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# The Economist

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Full contents
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Past issues/regional covers
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NEWS ANALYSIS

POLITICS THIS WEEK

BUSINESS THIS WEEK

OPINION
Leaders
Letters to the editor

WORLD
United States
The Americas
Asia
Middle East & Africa
Europe
Britain
International
Country Briefings
Cities Guide

SURVEYS

BUSINESS
Management Reading
Business Education
Executive Dialogue

FINANCE & ECONOMICS
Economics Focus
Economics A-Z

SCIENCE & TECHNOLOGY
Technology Quarterly

PEOPLE
Obituary

BOOKS & ARTS
Style Guide

MARKETS & DATA
Weekly Indicators
Currencies
Big Mac Index

DIVERSIONS

RESEARCH TOOLS

CLASSIFIED ADS

DELIVERY OPTIONS
E-mail Newsletters
Mobile Edition
RSS Feeds
Screensaver

ONLINE FEATURES
Cities Guide Go
Country Briefings Go
Audio interviews Go
Classifieds Go

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## Print Edition — February 10th 2007

**On the cover**
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**Previous print editions**
Feb 3rd 2007
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Jan 13th 2007
Jan 6th 2007
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### The world this week
Politics this week
Business this week

### Leaders
America and Iran
**Next stop Iran?**

Digital music
**Music wants to be free**

Private equity
**Caveat investor**

Bird flu and public health
**Under the influence**

Bangladesh
**Not uniformly bad**

### Letters
**On Israel and the Jewish diaspora**

### Special Report
Dealing with Iran
**A countdown to confrontation**

Israel and Iran
**How MAD can they be?**

### United States
The budget
**Fiscal frustrations**

The politics of the Iraq war
**Showcasing disunity**

Los Angeles' homeless
**On the skids**

Reviving Newark
**The phoenix of New Jersey?**

Shooting wolves
**In danger again**

Environment awareness
**No child left inside**

Health care
**God, sex, drugs and politics**

Visa policy
**Keeping out more than terrorists**

Lexington
**Rudy rising**

### The Americas
Haiti
**Building a reluctant nation**

Brazil
**Parliament or pigsty?**

Argentina
**Cooking the books**

Peru
**Sweet times**

Paraguay
**The next Chávez?**

### Asia
Bangladesh
**Everybody but the politicians is happy**

Japanese justice
**Confess and be done with it**

South-East Asia
**Let's all bash Singapore**

Australia's culture wars
**To flag or not to flag**

Chinese babies
**The golden pig cohort**

### A survey of European business
**Who are the champions?**
**Tomorrow the world**
**Home and abroad**
**Driving east**
**Buy, buy, buy**
**In the steps of Adidas**
**The chic and the cheerless**
**Not what it was**
**Funny business**
**Acknowledgments**
**Offer to readers**

### Business
The future of television
**What's on next**

Electronic Arts
**Looking forward to the next level**

Alstom v Bombardier
**Train wars**

German wine
**Better Spätlese than never**

Aviation in China
**Lofty ambitions**

Qantas Airways
**Fasten your seat belts**

Managing the military
**Back to school for the admirals**

Face value
**Digging deep**

### Special Report
Private equity
**The uneasy crown**

### Finance & Economics
Japan's currency
**Carry on living dangerously**

Weather risk
**Come rain or come shine**

Buttonwood
**Mutiny in the ranks**

American property
**Quite a performance**

Pensions for musicians
**When they're 64**

China's stockmarket
**Hot and cold**

Cash-handling in Germany
**We were Heros**

Economics focus
**A fluid concept**

### Science & Technology
Biotechnology
**Roses are blue, violets are red**

Children's medicine
**The ideal versus the best**

Economics and anthropology
**Patient capital**

Climate change
**Heating up**

## Middle East & Africa

Russia and the Middle East
**The bear is happy to be back**

The Gulf states
**Buying up art and culture**

Somalia
**It isn't nearly over**

South Africa
**Looking in the mirror**

Congo
**Keep the United Nations engaged**

Advertisement

## Europe

The Caucasus
**Hanging together**

Germany's nuclear power
**A policy of denial**

Europe's car emissions
**Setting the target**

Albania's energy problem
**Switching on the lights**

Italian football
**An unflattering reflection**

Turkey's Kurds
**Let justice be done**

Charlemagne
**Berlin Minus**

## Britain

Parliamentary reform
**What the Lords are for**

A soldier's death
**Mistaken identity**

Sainsbury's
**A trolley too far**

Bird flu
**Unruffled**

Public-sector efficiency drive
**Flaky figures** 🇬🇧

The attorney-general
**In the firing line** 🇬🇧

Regenerating Blackpool
**The last resort** 🇬🇧

Bagehot
**The real Labour funding crisis**

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## International

Muslims and socialists
**With friends like these**

Gifted children
**Bright sparks**

The World Bank and corruption
**My beautiful laundrette**

Advertisement

**The Richard Casement internship**

## Books & Arts

A critic of Islam
**Dark secrets**

American politics
**My life as an insider** 🇬🇧

British political history
**First among equals** 🇬🇧

Amazon worldwide bestsellers
**The history boys (and one girl)** 🇬🇧

Jacopo Tintoretto
**A tribute well earned** 🇬🇧

## Obituary

**David Rattray**

## Economic and Financial Indicators

**Overview**

**Output, prices and jobs**

**The Economist commodity-price index**

**The Economist poll of forecasters**

**Trade, exchange rates, budget balances and interest rates**

**Markets**

**Trade and output**

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Business Opportunity - WSI Internet Start Your Own Busines....

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Business Opportunity - WSI Internet Start Your Own Business! Profit....

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**Tenders**

Invitation for Prequalification
Hashemite Kingdom of Jordan Ministry of Finance for Supply and Implementation ....

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# Politics this week

Feb 8th 2007
From The Economist print edition

Reuters

The **Intergovernmental Panel on Climate Change**, whose job it is to try to assess what is happening to the atmosphere, published its fourth scientific report on February 2nd. It concluded, in terms somewhat stronger than the third report, that things are indeed getting hotter, and that mankind is, indeed, to blame. What to do about it will be addressed in other reports to be published later this year. See article

The **European Commission** said carmakers should be forced to increase the fuel efficiency of new cars by 20% within five years. Car companies said the target was an arbitrary figure and would lead to job losses in the EU as production moved elsewhere. See article

**Russian** prosecutors charged Mikhail Khodorkovsky, the former boss of the Yukos oil company and a critic of President Vladimir Putin, with laundering over $20 billion. Mr Khodorkovsky, who is already serving an eight-year prison term for fraud, said the new charges were designed to prevent his early release.

**Italy's** foreign minister, Massimo D'Alema, denounced as “unfortunate outside interference” a letter to an Italian newspaper from the ambassadors of America, Australia, Britain, Canada, the Netherlands and Romania. The envoys had called on Italy to give greater support to the NATO mission in Afghanistan. See article

Two **French Muslim** groups sued a satirical magazine for defaming the Prophet Muhammad by reprinting cartoons first published last year in Denmark. Nicolas Sarkozy, France's centre-right presidential candidate, gave his support to the magazine.

Some 160,000 turkeys were gassed at a farm in Suffolk to stop Britain's worst outbreak of **bird flu** from spreading. See article

## Put it in perspective

Flooding in Jakarta killed dozens of people and forced 340,000 to flee their homes. **Indonesia** is already struggling with an outbreak of dengue fever and is still grappling with bird flu, which has killed five people since the beginning of the year.

**Thailand's** military-backed government sacked the national police chief, ostensibly for failing to catch those who planted bombs in Bangkok on New Year's Eve. Separately, the government decided to reopen **Bangkok's** old airport, Don Muang, while it fixes the many faults found at the $4 billion Suvarnabhumi airport, opened only five months ago.

**Vietnam's** government unveiled plans for a $33 billion rail link between the capital, Hanoi, and Ho Chi Minh City in the south.

The design for a 40km (25-mile) **atom smasher** that will cost $8.2 billion was unveiled at a meeting in Beijing. Physicists want to discern one overarching set of laws that govern the universe and say the machine will help them make the discovery. The International Linear Collider, as it is known, will not start up until 2019 at the earliest and could be built in America, Japan or Switzerland.

## Adding it all up

George Bush sent his **budget** to Congress. The $2.9 trillion request asks for more funding for the military and reduces spending on health care and other domestic programmes over five years. It also forecasts reduced federal deficits that eventually reach a surplus in 2012. Sceptics wondered how this could be twinned with Mr Bush's request to extend his tax cuts. See article

**Rudy Giuliani** confirmed he was entering the presidential race. Although he did not make a formal declaration, the former mayor of New York filed the usual campaign papers and told a TV interviewer that "I'm in this to win". See article

The **Senate** was embroiled in debate on Mr Bush's policy on Iraq. Several resolutions ranging from support to outright condemnation of Mr Bush's plans have been produced and the parties are negotiating over which can proceed. See article

## Dangerous digs

An explosion killed 32 miners at a rudimentary coal mine in north-eastern **Colombia**. Days later, a second blast at another mine in the centre of the country killed eight.

In **Bolivia**, more than 20,000 miners marched through the capital, La Paz, in protest at plans by Evo Morales, the country's socialist president, for a sharp rise in taxes on mining. The government backtracked, saying the tax rise would apply to large privately owned mines and not to small mining co-operatives.

AFP

Opponents accused **Argentina's** government of fiddling the country's inflation figure after a senior statistician was sacked and her replacement changed the methodology of the consumer-price index. The government said inflation in January was 1.1%; economists said it was 1.5-2%. See article

More than a dozen gunmen attacked two state law-enforcement offices in the Mexican resort of **Acapulco**, killing seven people while videotaping the assaults. President Felipe Calderón sent some 8,000 troops to the area last month to crack down on drug-trafficking and organised crime.

## A new mission to accomplish

The killing in **Iraq** continued unabated, with at least 130 people, mostly Shias, dying in a single suicide-bombing in a Baghdad market. A "surge" of extra American troops into Baghdad was set to begin in an effort to quell the sectarian violence.

The **Palestinian** president, Mahmoud Abbas, head of the Fatah party, and his Islamist rivals from Hamas, represented by their leader-in-exile Khaled Meshal, started talks in Mecca to end weeks of factional fighting in the Palestinian territories.

**Egypt's** president, Hosni Mubarak, ordered a band of Muslim Brothers, including the group's number three, to be tried in a military court. Lawyers said that 165 members of the Brotherhood, the country's most popular opposition group, have been detained since December.

In Mogadishu, the capital of **Somalia**, sporadic night-time mortars and rockets were launched at the presidential palace, hotels and the port, presumably by remnants of the Islamist fighters, most of whom were routed a month ago by Ethiopian troops. An African Union peacekeeping force has yet to be assembled. See article

At the end of an eight-country tour of **Africa**, China's president, Hu Jintao, said he would try to cut his country's $3 billion trade surplus with the continent.

Reuters

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# Business this week

Feb 8th 2007
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**Vornado Realty Trust** withdrew its bid for **Equity Office Properties**, leaving the way clear for shareholders in America's largest real-estate investment trust to accept **Blackstone Group's** offer of $38.9 billion. The transaction sets a new record for a leveraged buy-out, underscoring the relentless takeover of public companies by private-equity firms. See article

Blackstone Group was one of four private-equity firms making up a consortium that expressed a keen interest in acquiring **J. Sainsbury**. The British supermarket chain has a market value of around £9 billion ($18 billion); if successful, the leveraged buy-out would be Europe's biggest. See article

London's latest landmark, the **Gherkin**, was sold for £600m ($1.2 billion), a record for the capital's booming commercial-property market. The seller, Swiss Re, will remain in the building as its main tenant until at least 2031.

Steve Jobs called for an end to **digital-rights management** technology that protects music sold over the internet. DRM was insisted upon by big record labels, but Mr Jobs thinks it is inhibiting the growth of the online-music market. Some observers reckoned that Apple's chief executive was trying to deflect criticism aimed at iTunes' own FairPlay system from regulators in Europe. See article

## The long and winding road

Meanwhile, a settlement was reached in a trademark dispute between **Apple** and **Apple Corps**, the Beatles' music company. The agreement gives Apple ownership of all the “Apple” logo trademarks, but the computer-maker will license some trademarks back to Apple Corps. The two sides have been arguing since the early 1980s; fans now hope they can come together and make the Beatles' songs available on iTunes.

There was more bother for **YouTube** over copyright infringement. **Viacom**, the owner of MTV, asked that all of its content be removed from YouTube's website after the two sides failed to reach a distribution deal. Meanwhile, Jeff Zucker chose his first day as boss of **NBC Universal** to chastise YouTube for failing to address media copyright on video clips.

**Eastman Kodak** unveiled its line of desktop printers and low-cost ink cartridges. Troubled Kodak is hoping its new products will encroach on Hewlett-Packard and others by addressing consumers' gripes about the cost of replacement cartridges for their printers (by weight, the ink within them costs more than caviar).

## A case to answer?

A three-man panel of a federal appeals court in San Francisco ruled that the biggest **sex-discrimination case** in American history could proceed against **Wal-Mart** as a class-action lawsuit. The suit was brought on behalf of past and present female employees, who claim the retailer is biased towards men in pay and promotion. An estimated 2m women could join it. Wal-Mart fulminated against the legal basis of the case and said it would fight all the way to the Supreme Court if it had to.

The long-running takeover battle for **Endesa** moved closer towards completion when the board of the Spanish energy company recommended **E.ON**'s latest €41 billion ($53 billion) offer to shareholders.

**HSBC** said that high rates of bankruptcy in America's subprime mortgage market meant it would take a much higher charge than expected (estimated to be around $10.5 billion) on bad debts for 2006.

With the threat of huge lawsuits against cigarette-makers seemingly receding in the United States, Britain's **Imperial Tobacco** decided to enter the market, agreeing to buy America's **Commonwealth Brands** for $1.9 billion.

Chung Mong-koo, the chairman of **Hyundai Motor**, received a three-year prison sentence for embezzling company funds. The jail term surprised those used to the comparatively light sentences handed down in South Korean corporate cases. However, the court decided not to send the head of the country's biggest carmaker to his cell straightaway, citing the need to protect the national economy during his appeal. Investors have been pushing for more transparency in the country's *chaebol*.

## Still full of eastern promise

The **Shanghai stockmarket** recovered somewhat after losing 11% of the value of its domestically traded shares in five days. The index surged last year, as improved earnings at Chinese companies spurred investor confidence. With one senior Chinese politician now warning that the market was overheated (and that most of the index's companies should be delisted), some pondered if this was the inevitable end to a Chinese bubble. Cooler heads said it was just a market correction. See article

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America and Iran

# Next stop Iran?

Feb 8th 2007
From The Economist print edition

**Why George Bush should resist a Wagnerian exit from the White House**

U.S. Air Force

Get article background

“WE ARE not planning for a war with Iran.” So said Robert Gates, America's new defence secretary, on February 2nd. You cannot be much clearer than that. With a weak and isolated president, and an army bogged down in the misery of Iraq, the American Congress and people are hardly in fighting mood. Nonetheless, and despite Mr Gates's calming words, Iran and America are heading for a collision. Although the risk is hard to quantify, there exists a real possibility that George Bush will order a military strike on Iran some time before he leaves the White House two years from now.

America and Iran have been at loggerheads ever since Ayatollah Khomeini's revolution of 1979. But four things are making this old antagonism newly dangerous. One is Iran's apparent determination to build nuclear weapons, and a fear that it is nearing the point where its nuclear programme will be impossible to stop (see article). The second is the advent of Mahmoud Ahmadinejad, a populist president who denies the Holocaust and calls openly for Israel's destruction: his apocalyptic speeches have convinced many people in Israel and America that the world is facing a new Hitler with genocidal intent. The third is a recent tendency inside the Bush administration to blame Iran for many of America's troubles not just in Iraq but throughout the Middle East.

Any one of these would be destabilising enough on its own. Added together, they make the possibility of miscalculation and a slide into war a great deal more likely. That is all the more so when they are combined with a fourth new source of friction between America and Iran. This is the predicament of Mr Bush. A president who is now detached from electoral considerations knows that his place in history is going to be defined by the tests he himself chose to put at the centre of his foreign policy: bringing democracy to the Middle East and preventing rogue regimes from acquiring weapons of mass destruction. Given his excessive willingness to blame Iran for blocking America's noble aims in the Middle East, he may come to see a pre-emptive strike on its nuclear programme as a fitting way to redeem his presidency. That would be a mistake.

## Never attack a revolution

This newspaper supported America's invasion of Iraq. We believed, erroneously, that Saddam Hussein was working to acquire nuclear weapons. And we judged that the world should not allow a mass-

murderer to gather such lethal power in his hands. In the case of Iran, the balance of risks points, though only just, in the other direction.

Even if it became clear that Iran was on the threshold of acquiring an atomic bomb, an American strike on its nuclear facilities would be a reckless gamble. Without America invading and occupying Iran—unthinkable after Iraq—such a strike would at best delay rather than end Iran's nuclear ambitions. It might very well rally support behind a regime that is at present not conspicuously popular at home, emboldening it to retaliate inside Iraq, against Israel and perhaps against the United States itself. Besides, it is far from clear exactly how dangerous a nuclear-armed Iran would be. Unlike Iraq under Saddam, Iran has a complex power structure with elements of pluralism and many checks and balances. For all its proclaimed religiosity, it has behaved since the revolution like a rational actor. To be sure, some of its regional aims are mischievous, and in pursuing them it has adopted foul means, including terrorism. But the ayatollahs have so far been shrewd calculators of consequences. There are already small signs of a backlash against the attention-seeking Mr Ahmadinejad. Like the Soviet Union, a nuclear Iran could probably be deterred.

## But don't think Iran isn't dangerous

All of this suggests that in present circumstances it would be wrong for America to launch a military strike against Iran. But it would be the height of self-deception for anyone to jump to the conclusion that a nuclear-armed Iran would not be dangerous at all. It would be very dangerous indeed.

For a start, there is a danger that Iran's nuclear efforts will provoke a pre-emptive strike by Israel, which is already a nuclear power, albeit an undeclared one. For Israelis, whose country Mr Ahmadinejad says he wants to wipe off the map, it is not all that reassuring to hear that Iran can “probably” be deterred. Even if Israel were to decide against such a strike, Iran's going nuclear could destroy what is left of the international non-proliferation regime. It has proved hard enough for Arab states such as Egypt and Saudi Arabia to live with Israel's undeclared bomb; if their Iranian rival got one too, the race to copy might soon be on. On top of this is the danger that a nuclear Iran would feel safe to ramp up attempts to spread its revolution violently beyond its own borders.

Every effort should be made to stop an Iranian bomb. But there is a better way than an armed strike. In 2002 Mr Bush consigned Iran along with Iraq and North Korea to an “axis of evil”. Since 2004, for lack of good alternatives, he has been helping the efforts of Britain, France and Germany to talk rather than bludgeon Iran into nuclear compliance. Iran claims that its nuclear programme is for civil purposes only. Last year, the Europeans called its bluff by offering trade, civil-nuclear assistance and a promise of talks with America if it stopped enriching the uranium that could produce the fuel for a bomb. When Iran refused, diplomacy led in December to the imposition of economic sanctions by the Security Council.

This is a promising approach. The diplomacy at the United Nations proceeds at a glacial pace. But Iran is thought to be several years from a bomb. And meanwhile the Americans, Europeans, Russians and Chinese have at last all lined up on the same side of the argument. What is required now is a further tightening of the economic squeeze coupled with some sort of an incentive—most usefully an unambiguous promise from Mr Bush that if Iran returns to compliance with the nuclear rules it will face no attempt by America to overthrow the regime. Even then, America and Iran may be fated to lock horns in the Middle East. But the region, and the world, will be a good deal safer without the shadow of an Iranian bomb.

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Digital music

# Music wants to be free

Feb 8th 2007
From The Economist print edition

**Everyone will benefit if digital music is sold without copy-protection**

Landov

IT IS not often that the company that dominates an industry, and is thus most wedded to the status quo, calls for the rules that govern the business to be changed. But that is what happened this week when Steve Jobs, the boss of Apple—which dominates digital music with its iPod music-player and iTunes music-store—published an essay on his firm's website under the unassuming title “Thoughts on Music”.

At issue is digital rights management (DRM)—the technology guarding downloaded music against theft. Since there is no common DRM standard, songs purchased for one type of music player may not work on another. Apple's DRM system, called FairPlay, is the most widespread.

European regulators have been gunning for Apple. They regard its refusal to license FairPlay as monopolistic. Since music from the iTunes store cannot be played on non-iPod music-players (at least not without a lot of fiddling), any iTunes buyer will be deterred from switching to a rival device. Last year, French lawmakers drafted a bill compelling Apple to open up FairPlay to rivals.

In the past, Apple has supported DRM on the grounds that it kept the pirates at bay. It described the French bill as “state-sponsored piracy”. But this week Mr Jobs gave an alternative explanation for defending DRM: the record companies' demands. They agreed to make their music available to iTunes only if Apple agreed to protect it using DRM; indeed, they can still withdraw it if the DRM system is compromised. Apple cannot license FairPlay to others, says Mr Jobs, because it would depend on them to produce security fixes promptly. So, he suggests, why not do away with DRM and sell music unprotected? “This is clearly the best alternative for consumers,” he declares, “and Apple would embrace it in a heartbeat.”

Why the sudden change of heart? Mr Jobs is presumably keen to get Europe's regulators off his back. Rather than complaining to Apple about its use of DRM, he suggests, “those unhappy with the current situation should redirect their energies towards persuading the music companies to sell their music DRM-free.” Two and a half of the four big record companies, he helpfully points out, are European-owned.

## Rhythm and dues

But, politics aside, getting rid of DRM would probably be good for Apple. It can afford to embrace open

competition in music players and online stores. Consumers would gravitate to the best player and the best store, and at the moment that means Apple's. Mr Jobs is unfazed by rivals to the iPod: he notes that, since only 3% of the music in a typical iTunes library is protected, most of it can already be used on other players today. So Apple's dominance evidently depends far more on branding and ease of use than on DRM-related “lock-in”.

It would probably be good for everybody else, too. Consumers would benefit because all music and all devices would become compatible. Record companies worry about piracy; but most of the music they sell is still on CDs—a far bigger source of piracy than the internet—and they would benefit from higher sales that greater compatibility would bring. Lots of small labels already sell DRM-free music, and some of the giants are trying it out. Which may be another reason for Mr Jobs's change of heart: having seen which way the wind is blowing, he wants to be regarded not as a defender of DRM, but as a consumer champion who helped bring it down.

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Private equity

# Caveat investor

Feb 8th 2007
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**The real risks of private equity**

Sharon Tancredi

TAKE an underperforming company. Add some generous helpings of debt, a few spoonfuls of management incentives and trim all the fat. Leave to cook for five years and you have a feast of profits. That has been the recipe for private-equity groups during the past 20 years.

Private equity has been so successful that it is getting ever bigger and bolder (see article). Rarely a day goes by without some new multi-billion-dollar scheme. On the table now are J. Sainsbury, a British retailer, and Equity Office Properties Trust, an American property group—which, valued at some $40 billion, would be the biggest deal ever.

Rampant expansion has won private-equity groups plenty of enemies. In 2005 Franz Münterfering, a German politician, described them as “locusts”, intent on sacking workers and making a quick euro. More recently, Philip Jennings, the general secretary of the UNI trade union, summarised the industry's philosophy as “buy it, strip it and flip it”. Some fret about the growing tendency for private-equity groups to club together to bid for large companies—is that anti-competitive behaviour or simply a wise effort to spread risk? Others complain about the conflicts of interest in management buy-outs. Might not executives with inside knowledge help a private-equity group buy their company cheaply so as to make more money years later when it is eventually sold on?

Some of this fuss reflects the culture shock in countries suddenly facing the full rigours of Anglo-American capitalism. To the extent that private-equity groups release capital from unprofitable firms and supply it to thriving ones, so much the better. Private equity arguably represents an improvement on late 20th-century governance, when management and ownership were strictly separated. By contrast, private-equity groups keep a close interest in the companies they own, while executives benefit from the discipline of incentives and a high debt burden, which stops them wasting cash.

Because the ultimate buyers want a company with prospects, private-equity groups tend not to trash the businesses they back. Research by American academics has found that companies refloated on the stockmarket after private ownership performed better than other new issues did. Club deals are less about collusion than about pursuing quarry that a single fund would have trouble swallowing. And although in theory the danger exists that managers may collude with private-equity purchasers to cheat shareholders out of a fair price, in practice buyers seem more at risk of paying too much.

## The other PE ratio

The people who should really be concerned about the private-equity boom are rarely mentioned: investors. The rush into private equity is part of a drive into “alternative” assets (a category that also includes hedge funds, property and commodities) and away from shares and government bonds. But private-equity returns are not really very “alternative”, since the forces that drive them also drive the stockmarket. As the manager of a traditional fund puts it: “I fail to understand why it's a good idea for clients to take money away from me and give it to private-equity groups who charge higher fees for buying quoted shares at a 20% premium.”

Studies suggest that investors have so far done well out of private equity, with the average buy-out fund beating the S&P 500 index in 1980-2001. But these figures come with a large health warning. First, the 1980s and 1990s saw generally falling interest rates and rising share prices—the ideal background for private equity to succeed. Second, the modern private-equity industry is built on a far greater scale than a decade ago.

In 1991 just 57 funds jostled for deals, according to Private Equity Intelligence, a research firm; by the end of last year, 686 were in the chase. The $430 billion private-equity funds raised was more than the industry drummed up between 1990 and 1998. As more money piles into the business, groups could lose their focus, and competition could push up the prices for deals and force down future returns. Indeed, research shows that the more money is raised by private-equity funds in any year, the lower returns tend to be. The last peak for fund-raising was 2000, the year of the dotcom crash.

And there is a sting in the tail. A small number of private-equity groups consistently earn above-average returns, whereas the rest do far less well. New investors may be unable to gain access to the top groups and end up funding the laggards. If the benign conditions of the 1980s and 1990s are not repeated, those investors could be sorely disappointed.

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Bird flu and public health

# Under the influence

Feb 8th 2007
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THE British press does love a good panic. It did its best to stir one up over the weekend after some turkeys on a farm in the east of the country contracted influenza of the dreaded H5N1 strain, and it transpired that 160,000 birds were going to have to be killed and cremated in order to stop the disease spreading (see article). Questions were asked about whether the government had reacted too slowly in imposing a quarantine zone around the infected farm (no doubt the opposite questions would have been asked had such a zone been imposed as the result of a false alarm). Grave advice was dispensed on whether or not turkey meat was still safe to eat (it is). But most of all, everyone worried about the implications for human health of what is—though it has indeed claimed some human victims—still basically a bird disease.

## Don't panic

That worrying matters—not because there is no risk to human health (there is, but it is small and restricted to those who come into close contact with infected birds), but because such panics risk doing two opposing things. One is that they act as “social vaccines”, inuring public opinion to the need for vigilance. The other is that they focus anxiety on the particular, when it is the general that needs attention.

Avian influenza H5N1 was first identified in 1997 when there was a huge outbreak in Hong Kong. After that shaky start, the world has responded fairly well to the risk of this particular virus mutating in a way that would allow it to pass from person to person rather than merely from bird to person. Drugs that act against a range of influenza viruses are being stockpiled for rapid deployment. The planet's vaccine-making infrastructure is about to be overhauled to allow billions of doses, rather than mere millions, to be churned out—and much of the new capacity will be built in poor countries. In some places, at least, ruthless monitoring of poultry flocks has reduced both the avian disease and the (already rare) cases of people becoming infected.

When it comes to the monitoring, there are some unlikely heroes. Vietnam's frightening bureaucracy has been deployed so effectively that no human case of avian flu has been seen in the past year—though

China, in the past, used its own bureaucracy to cover the disease up. Identifying human cases and isolating them quickly is important because the shortest route to a version of the disease that is dangerous to the whole of humanity rather than just vets and poultry farmers is simultaneous infection with both bird influenza and the human variety, and the exchange of genes between the two. This could create a form of the disease that has the virulence of the avian infection, but which passes from person to person with the ease of the human one.

However nasty influenza is, though (and it can be very nasty indeed), it is what Donald Rumsfeld would call a known unknown. Drugs can be deployed; vaccines developed; victims quarantined. What should really worry policymakers is the unknown unknowns.

That animal diseases jump the species barrier from time to time is well understood. AIDS, for example, is caused by a chimpanzee virus that made the leap around 1930, whereas severe acute respiratory syndrome (SARS) came from either bats or civets in 2002. But no one knows which disease will be next, what animal will be its natural host, where it will happen, or how dangerous it will be.

In the face of that uncertainty, the most important thing is to have monitoring systems in place that are able to pick up unusual symptoms—any unusual symptoms. AIDS spread unnoticed in Africa for around half a century. When it arrived in America it was detected within months thanks to the vigilance of the country's Centres for Disease Control and Prevention in noticing clusters of a previously rare skin cancer that is often a symptom of immune-system collapse.

The sort of global vigilance that could detect a rare cancer becoming slightly less rare is hard to imagine, and would certainly be expensive. But compared with the damage that could be done by a pandemic—whether slow-burning like AIDS or the wildfire of influenza—it would be money well spent. Yet even today's small sums are paid out in the wrong place. Diseases emerge in Africa and Asia, where people mingle with animals day in, day out. That is where the monitoring and the research needs to go on. Cross-border co-operation is never easy, but if rich-world governments want to protect their citizens, the place to start is in a foreign field.

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**Bangladesh**

# Not uniformly bad

Feb 8th 2007
From The Economist print edition

**The army has intervened sensibly in Bangladesh's failing democracy. Now it must leave**

AFP

Get article background

LIKE most human follies, military coups sound good at the time; and always fail. They sound good because what they replace is usually bad: riotous civilian leaders, corrupted institutions, stolen elections. They fail because beneath the chaos are political problems that soldiers cannot unpick. Bangladesh's generals took power by stealth on January 11th, forcing the president to declare a state of emergency and appoint a government of technocrats to do their bidding. One month on, this administration has fallen into the usual trap of failing to set a date for the election it has promised. All the same, this was a peculiar coup, and its failure is not yet assured.

Generals always claim to have been forced to take action. In this case the claim is true (see article). The democratic process had collapsed. The government they unseated was itself an unelected administration that had been appointed by the outgoing regime, led by the Bangladesh Nationalist Party (BNP), to supervise an election on January 22nd.

This caretaker arrangement was the result of chronic distrust between the BNP and its main rival, the Awami League (AL): neither of the parties, which have ruled Bangladesh alternately for the 16 years since its previous military government, trusts the other to hold a fair poll. The arrangement broke down mainly because the BNP picked a partisan caretaker to rig the poll. The AL screamed foul, boycotted the election and called its thugs onto the streets. More than 40 people were killed in political violence late last year. Had the election been held, there would have been a slaughter.

The generals were entitled under the constitution to avert this. But they and the technocrats they have appointed should understand that their duty now is limited. It is to organise, as swiftly as possible, the fairest election that Bangladeshis can reasonably hope for. And here a problem is emerging.

The administration has pledged to bring to justice top-level criminals (who are mostly politicians), depoliticise institutions, rewrite the electoral roll and take other measures that it says are essential to holding fair elections. It has also vowed to fix a power crisis, liberalise fuel prices and otherwise improve the economy. Its performance has so far been so good, and the memory of the BNP and what followed it is so painful that most Bangladeshis seem happy. But it will not last: Bangladesh is too troubled for the administration to achieve a fraction of its goals before the people lose patience. And Bangladeshis are a demanding lot. They rallied to drive the previous army government from power, and their continued zest for politics is one reason Bangladesh is so explosive.

The other is their appalling leaders, the BNP's Khaleda Zia and Sheikh Hasina Wajed of the AL—the women Bangladeshis call the “two begums”. Both inherited their parties from assassinated relatives, and have turned them into patronage-based personality cults. They also hate each other, and refuse to communicate, much less negotiate. The army hopes its crackdown might persuade the begums to retire. That would be as wonderful as it is unlikely. They are too popular and too good at mob politics to be ousted.

## No bypassing the politics

It is in fact the generals who must withdraw, after an election by the end of the year that they have done their best to ensure is fair. That will give Bangladeshis the opportunity, though perhaps a few elections hence, to start to resolve their problems peacefully. Such problems cannot be ended by military fiat. The feud between the two begums is a distorted image of many nationwide divisions: between the cities and the villages, between secular and religious, between those who fought for liberation from West Pakistan in 1971 and those, including many of the BNP's Islamist allies, who opposed it.

The country's wider problems call for a change in thinking. Bangladesh is uniquely imperilled by the main threats to global security: climate change, terrorism and state failure. Almost half the overpopulated country lives near sea level; 40% of its area is flooded each year. It would be miraculous if the army's intervention shocked the country's battling small-minded politicians into a new and urgent policy of building dykes and embankments against the rising seas.

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# On Israel and the Jewish diaspora

Feb 8th 2007
From The Economist print edition

The Economist, 25 St James's Street, London SW1A 1HG
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## On the diaspora

SIR – Your leader on the Jewish diaspora criticised mainstream American Jewish organisations on a number of grounds for continuing to support Israel ("Diaspora blues", January 13th). You based these criticisms on the premise that Israel's existence is now taken for granted by most of the world and that some diaspora Jews don't support Israel because "the threat of genocide or of Israel's destruction has receded". How I wish your premise were true.

While Israel has developed enormously on the economic and technological fronts, and while some Arab states now acknowledge Israel's reality, in fact the threats to Israel are as grave as have existed for decades. Iran, which aspires to be the world's next nuclear state, has explicitly and repeatedly threatened the existence of the state of Israel and denied the existence of the Holocaust. Almost all of Israel's Arab neighbours still refuse to recognise Israel's legitimacy and Hamas, Hizbullah and other extremist groups make sure that rocket attacks and suicide-bombings are daily threats to Israeli civilians. How all of this translates into the reduced vulnerability for Israel that you suggest is hard to comprehend.

Glen Lewy
National chair
Anti-Defamation League
New York

SIR – I found your article on Israel and the Jewish diaspora well written and researched ("Second thoughts about the Promised Land", January 13th). However, it suffered from a strong Anglo-Saxon bias and a short historical perspective. There have always been differences in opinion between the broader Jewish population and Jewish organisations and this is because most of these groups are not elected (they are better defined as "interest groups"). Moreover, Jewish opinion in Europe was divided between Zionism and other streams of Jewish identity during the whole of the 20th century. I do not see any significant change in these trends. What is changing is the greater visibility of some old differences.

Tomas Jelinek
Ex-president of the Prague Jewish Community
Prague

SIR – In order for there to be a peaceful settlement in the Middle East, the Jewish neoconservative groups lobbying for "not Israel but its right-wing political establishment" must moderate their views. Bloodshed will remain the norm and nothing will be accomplished until there is constructive diplomatic dialogue between America, Iran and Syria and between Israel and the Palestinians.

Gregory Salomon
Houston

SIR – Criticism of the Jews' "knee-jerk defensiveness of Israel" ignores the very real need that Jews feel to defend Israel's honour from the persistent double-standard to which it is held. In 2000 Israel offered the Palestinians a state on virtually all of the land in dispute, only to see the Palestinians respond by strapping bombs to their own children and sending them into Israel to massacre civilians. Yet today it is Israel, rather than its warmongering neighbours, that is treated as an obstacle to peace. Even Vladimir Putin, who has pursued a scorched-earth policy in Chechnya, has the audacity to accuse Israel of acting "disproportionately" when Israel responds with relative restraint to Hizbullah's missile barrages. Instead

of criticising diaspora Jews for standing up for Israel, you should fault the rest of the world for lacking the courage to do so.

Stephen Silver
Walnut Creek, California

SIR – If anyone thinks Jews do not feel the Palestinians' pain and speak up about it among ourselves, I assure you that we do. But someone on the Palestinians' side needs to stand up for peace. The day that one of their leaders comes to Israel to say “We want peace”—as Anwar Sadat did—there will be a reasonable and contiguous Palestinian state. No Israeli government could stand in its way. Until then the attacks on Israel will continue and Israel's defenders will continue to do what they must to protect its security. I suppose you may consider it unfair, but I'm tempted to say that your underlying message was, “Why don't you people know your place and stop being so disruptive (and effective) in world political circles.”

Judd Kessler
Washington, DC

SIR – I take issue with your assertion that Poland is a “cradle of anti-Semitism”. This stereotype echoes the oft-repeated fiction about “Polish” concentration camps (actually, Nazi camps located in Poland). Prior to 1939 Poland was home to the biggest Jewish diaspora in Europe and I wonder how you square your view with the fact that so many Poles risked their lives to rescue Jews during the Holocaust. Indeed, the Polish constitute the largest group of the Righteous Among the Nations, the honorary title granted to all non-Jews who saved Jewish lives by Yad Vashem, the organisation charged with commemorating the Holocaust.

No one can deny the existence of Polish anti-Semites, or of shameful acts of anti-Semitism in Polish history. But you did not substantiate why modern-day Poland is a cradle of anti-Semitism. This is unjust. The real cradle of anti-Semitism is the intolerance and prejudice that rear their ugly heads irrespective of national borders.

Piotr Zientara
Gdynia, Poland

SIR – You characterised the relationship between pro-Israel lobbies and evangelical Christians as an “unholy alliance”. Although there are certainly those who warrant that description, it is unfair to portray all Christians who fervently support Israel as diabolic. Many Christians give their support because they believe a Jewish homeland has the right to exist, not because of some warped interpretation of Judgment Day.

James Tanner
Greenwich, Connecticut

SIR – Though the grandchild of Holocaust survivors, I was glad to see Charlemagne criticising laws in Europe that criminalise Holocaust denial (January 27th). But he didn't go far enough. Instead of debating freedom of speech, Europeans should be focusing on their freedom to analyse history. Holocaust denial posits an alternate—albeit entirely inaccurate—reading of the past. Does the European Union really want to start laying down what is “official” history, declaring certain accounts kosher and others illegal?

Jon Grinspan
New York

SIR – With the reams of detailed first-hand and scholarly accounts available, there can be no reason why a sane, rational person would deny the Holocaust, other than an abiding hatred of the Jewish people. So the question is: should such hate speech fall under the legal protection of free speech? There will always be those who hate Jews (and other people as well). I don't see why their right to spread hatred should be protected.

Steve Herskovits
New York

SIR – American Jews, or any other Jew for that matter, will never lose their support for Israel; it is the Jewish people's answer to anti-Semitism in the world and celebrates our resolve never to be destroyed.

David Mandel
High-school student
Glencoe, Illinois

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Dealing with Iran

# A countdown to confrontation

Feb 8th 2007
From The Economist print edition

Rex Features

**Can anything deter Iran from its nuclear ambitions?**

Get article background

THE streets of Iran are festooned this week with revolutionary bunting. Black and green banners commemorating the martyrdom of the third Shia imam, Hussein, still flutter from lamp-posts, even though the mournful Ashura rites of late January are over. They now hang beside flags looking forward to February 11th, when Iranians mark the anniversary of the Islamic revolution of 1979.

Such celebrations usually go unnoticed in America. But not this time. The two countries are moving slowly towards confrontation, both over Iraq—where Iran is meddling—and over Iran's nuclear programme. Its provocative president, Mahmoud Ahmadinejad (above right), has hinted that February's celebrations will include “good news” about the progress of nuclear work. Iran says it is fiddling with uranium and plutonium to produce more electricity. But America and many other countries suspect it is building a bomb.

Last month, when President George Bush announced the deployment of extra troops in Iraq, he also laid out a new strategy to confront Iran. A second carrier strike group, led by the *USS John Stennis*, is about to join the *USS Dwight Eisenhower* in the Gulf region. American aircraft will patrol more aggressively close to Iran's airspace. At about the same time as Mr Bush's speech, American forces raided an Iranian office in Arbil, in Iraq, and arrested five men. On January 26th Mr Bush appeared to confirm that he had authorised American forces to kill or capture Iranian agents in Iraq, where they are accused of providing training and sophisticated weapons to Iraqi insurgents. In the words of John Negroponte, America's outgoing director of national intelligence, Iran is beginning to cast a shadow over the whole Middle East.

The United States says it has no intention of attacking Iran's nuclear facilities. Robert Gates, the new defence secretary, stresses that “We are not planning for a war with Iran.” But he will not take the military option off the table. One line of thought is that since Mr Bush is not up for re-election, and because his legacy will be defined mostly in terms of security, he might not be prepared to leave office with the Iranian question unresolved, especially if he looks likely to be succeeded by a Democrat. That points to the possibility, at least, of a military strike.

Those keen to avoid a conflict over Iran's nuclear ambitions now pin their hopes on diplomacy toughened by sanctions. Iran has repeatedly rejected an offer made more than a year ago by Britain, France, Germany, America, Russia and China to persuade it to stop its troubling activities. That offer included a

proper dialogue with America, improved trade and political ties, co-operation in less proliferation-prone nuclear technologies that would have allowed Iran to produce electricity, but not weapons, and discussions on regional security. Now tougher measures are being tried.

After months of haggling, in late December the United Nations Security Council passed Resolution 1737, for the first time ordering, rather than asking, Iran to halt its suspect nuclear activities. Sanctions were imposed on ten organisations and 12 individuals involved in either Iran's nuclear or its missile programmes, or both. Further measures may follow unless, within 60 days, Iran suspends its uranium and plutonium-related work and resumes talks.

Time is almost up, and Iran remains defiant. Its president has called the UN resolution a “piece of torn paper”. That attitude seems self-defeating. Iran is not isolated, as North Korea is: it depends heavily on trade, and not just as a seller of oil. Two-thirds of its population is under the age of 30, and unemployment is high; it needs to attract as much outside investment for its oil and gas industry, and finance for building roads and other projects, as possible. Already, the investment pinch from sanctions is being felt across the country: the government now offers cash for some priority jobs, such as building oil refineries, but it struggles to attract reputable international contractors to build them. Sanctions have a better chance of working here than they did in North Korea. But will better be good enough?

For Iran's clerical regime, gaining advanced nuclear technology means irresistible regional clout. By declaring Iran a member of the “nuclear club”, Mr Ahmadinejad puts his country on a par with India and China—as well as Israel (see article). Meanwhile, at home, nuclear achievements are a way to rally popular support round Iran's “inalienable” right to whatever nuclear technologies it chooses. The regime calculates that it can ride out sanctions, and so far it has been proved right. Ordinary Iranians barely feel them: the shops of Tehran are still crammed with foreign goods, from televisions to cornflakes.

Iran has also been doing its damnedest to exploit what it perceives to be divisions within the Security Council, and especially among the six heavies that have taken the diplomatic lead against it. They are in many ways a disparate bunch. Russia, the country Iranian officials have been counting on to protect them from real pressure, deliberately dragged its feet at the UN. It knew America was impatient for results and wanted to flex its muscles. But Russia also wanted to protect its investment in the nuclear reactor it is building for Iran at Bushehr. Tortuous exemptions were written into Resolution 1737 to enable Russian companies to be paid for construction costs, the future supply of reactor fuel, and even for anti-aircraft missiles recently sold to Iran (see article) that could be used to protect its nuclear sites against attack. China, a big buyer of Iranian oil, is no keener on sanctions than Russia is.

Yet the six have nonetheless managed to keep in step. Over the past year America's secretary of state, Condoleezza Rice, has persuaded Mr Bush to keep the diplomacy on track, both by accepting that Iran can have a nuclear programme (just not a weapons-building one) and by agreeing that, if Iran does decide to suspend its nuclear work, America will join in serious talks “any time, anywhere”. Those were big concessions from what Iran likes to call “the Great Satan”. Meanwhile Russia, for all its truculence, has repeatedly delayed supplying the nuclear fuel for Bushehr.

So the six all still see mileage in their diplomatic efforts. And already, in diplomatic terms, Iran is quite isolated. Although it claims the backing of the 114 members of the non-aligned movement for its right to enrich uranium, many are unhappy at its defiance of the Security Council and the International Atomic Energy Agency, the UN's nuclear guardian.

The ponderous process of adopting a new sanctions resolution at the UN will probably get under way next month. But Iran is already feeling a much sharper pinch from financial sanctions that do not require further UN approval. Operating under the United States Patriot Act, as well as on the basis of a presidential directive adopted in 2005 to target the funds of proliferators, officials from America's Treasury Department have been criss-crossing the globe to persuade governments and banks to curb their business with Iran.

As a result, Iran is finding it increasingly expensive to borrow money. Foreign government-backed credits are getting harder to come by; Japan is among countries that have scaled back their plans to invest in Iran's oil and gas industries. Even legitimate businesses are suffering, as foreign banks find it hard to be certain that the transactions they handle are not being diverted, for nefarious purposes, through Iran's network of front companies. All dollar exchanges, including small transfers for private individuals, have become extremely complicated, and it is very hard to use a credit card to buy online from inside Iran. Already capital is fleeing the country, much of it reportedly ending up in Dubai.

Inside Iran a heated debate is now under way over how to respond to its growing isolation and the prospect of more sanctions to come. There are signs of rising popular discontent with Mr Ahmadinejad's firebrand rhetoric and his capricious management of the economy—as well as worries about sanctions, and how much the nuclear programme will cost Iran. More pragmatic politicians, such as Ayatollah Akbar Hashemi Rafsanjani, would prefer to re-open negotiations with the West to avoid open confrontation.

When Mr Ahmadinejad and his allies did badly in recent local elections, criticism came into the open. Last week, for the first time, a newspaper editorial even argued the case for suspending nuclear work, as the UN has demanded. Mr Ahmadinejad's wings have been clipped a little. But there is no sign yet that Iran's leaders will reconsider their nuclear ambitions.

## The ticking atom bomb

Last summer Mr Negroponte reckoned that Iran could become a nuclear power sometime between 2010 and the middle of the next decade. A recent study by the International Institute for Strategic Studies (IISS) in London reckoned that it would take two to three years “at the earliest” for Iran to go nuclear.

Once Iran has learned how to enrich uranium to make nuclear fuel, it will quickly be able to make highly enriched uranium for bombs. So far, it has assembled two experimental “cascades” of 164 interconnected high-speed centrifuges to produce small amounts of the low-enriched sort. It may soon announce the first cascades in the underground hall at Natanz, where it seeks to link up 3,000 centrifuges by June. Once up and running, these could produce enough highly enriched uranium for one bomb in less than a year—if left undisturbed.

AFP

**Small but defiant**

Nuclear experts, however, are sceptical about Iran's real progress. Running high-speed centrifuges reliably for a long period of time is a difficult task which Iranian engineers appear not to have mastered. According to the IISS, setting up the 3,000-centrifuge plant would be a “political act”, designed to show defiance and improve Iran's bargaining position if negotiations are resumed.

Israel, which has tried for years to mobilise international action against Iran, suddenly appears more sanguine. Ehud Olmert, the prime minister, this week insisted “there is still time” to apply diplomatic pressure. Many people, including America's vice-president, Dick Cheney, have suggested that Israel could take matters into its own hands and bomb Iran's nuclear facilities as it did Saddam Hussein's Osirak nuclear reactor in 1981. But the task may defeat even Israel's air force. Iran has buried many of its nuclear facilities deep underground and has carefully dispersed them, so there is no single target. Senior Israeli security officials argue that, if there is to be military action, it should be carried out by the United States.

Arguably, the best opportunity for a surgical strike has already passed. The Isfahan conversion plant, which produces uranium hexafluoride (UF6, the uranium compound that is passed as a gas into the centrifuges to be enriched), is above ground and vulnerable to attack. It was the first part of the nuclear programme to be restarted by Iran in 2004, and has since produced about 250 tonnes of UF6—enough for 30-50 atomic bombs. But it is now thought to be stored in underground bunkers, much harder to hit.

Another choke-point is the Natanz enrichment facility; but this is buried some 15-18 metres under soil and concrete, and modern bunker-busting bombs might not be able to destroy it. The use of ground forces to secure the area long enough to do the job would be highly risky; the use of a low-yield nuclear weapon, as some suggest, might work physically but is hardly conscionable politically—or morally.

In any case, centrifuges can be rebuilt and hidden elsewhere in a large, mountainous country like Iran. A study last August by the Centre for Strategic and International Studies (CSIS), a think-tank in Washington, DC, said there were 18 known nuclear sites, many of them underground or close to populated areas, and perhaps as many as 70 unknown ones. One place alone, the Parchin military complex (where research on nuclear warheads may be being done), has hundreds of bunkers and several tunnels.

Many of the sites are protected, and any operation would have to suppress at least part of Iran's air defences, and all its missiles and naval power, to limit any retaliation. The CSIS study concluded that even a large-scale attack, taking several weeks to complete, could leave much of Iran's technological base intact, and allow the country eventually to reconstitute an underground nuclear programme. In short, it would be very difficult to stop a determined Iranian regime from going nuclear, either by military action or by sanctions, if it were willing to pay the cost.

## The cost of striking

Military action could be painful not just for Iran, but for America as well. The Muslim world would see it as yet another instance of “attacking Islam”. Iran, moreover, has several means of retaliation. It could fire missiles at American bases or Israel, perhaps tipped with chemical or biological weapons. It could also attempt to close off the flow of oil from the Gulf.

A less overt response would be to stir up its allies to attack coalition forces in Iraq and Afghanistan. Iran could do much worse than its current meddling in those places. (Indeed, though its political influence in Iraq is undisputed, the scale of its military involvement in the anti-American insurgency has still not been proved for sure.) It could also resort to terrorist tactics farther afield, perhaps even assisting al-Qaeda, some of whose leaders may be under house arrest in Iran.

AFP

**How much will she suffer for what her government does?**

According to Mr Negroponte, the ability to carry out terrorist attacks is “a key element” of Iran's security strategy. “It believes this capability helps safeguard the regime by deterring United States or Israeli attacks, distracting and weakening Israel, enhancing Iran's regional influence through intimidation, and helping to drive the United States from the region,” he said last month. For the moment, everything Iran does is drawing America in closer, and the risks of an Iranian miscalculation are growing by the day. But America is still uncertain which is worse: to let Iran go nuclear, or to try to stop it by force.

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Israel and Iran

# How MAD can they be?

Feb 8th 2007 | TEL AVIV
From The Economist print edition

## Deterrence and its limits

Get article background

EVEN if Iran got the bomb, it would know that Israel had one too, and that knowledge would deter both countries from using their weapons, just as the doctrine of “Mutual Assured Destruction” kept America and the Soviet Union at peace during the cold war. That is the soothing assumption of those who say Israel can live with a nuclear Iran. Is it correct?

In the cold war, the foes were both big countries with big populations. But at 65m Iran's population is ten times bigger than Israel's, and Iran is 80 times bigger. In 2001 Ayatollah Akbar Hashemi Rafsanjani, Iran's once and perhaps future president, mused ominously in a Friday sermon that “an atomic bomb would not leave anything in Israel, but the same thing would just produce damage in the Muslim world”.

This lack of symmetry may be more apparent than real. Israel is reckoned to have around 200 nuclear warheads, more than enough to destroy all Iran's towns and cities. Some strategists argue that tiny Israel could be disabled by a first strike. But to prevent any Israeli retaliation, an Iranian attack would not only have to overcome Israel's Arrow air-defence missiles and destroy its airfields but also penetrate the silos of its nuclear-tipped Jericho missiles. In recent years, moreover, Israel is rumoured to have put nuclear cruise missiles on board its three Dolphin submarines.

In contemplating an attack on Israel, Iran would have also to weigh the (possibly nuclear) reaction of the United States. “In the event of any attack on Israel,” George Bush said last May, “the United States will come to Israel's aid.” If Iran got the bomb, America might formalise this promise—and maybe put an umbrella of “extended deterrence” over other American allies in the region.

All in all, this suggests that deterrence can be made to work. But for Israel it would still be a gamble. During the cold war America and the Soviet Union communicated constantly in order to avoid a miscalculation. Even so, they came close to nuclear war over Cuba. Iran, in contrast, refuses to talk to “the Zionist entity”, and its president yearns noisily for Israel's disappearance. Indeed, his apocalyptic threats have started to erode the previous conviction of most Israeli analysts that, for all its proclaimed religiosity, Iran is still a rational actor.

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The budget

# Fiscal frustrations

Feb 8th 2007 | WASHINGTON, DC
From The Economist print edition

**George Bush's budget has scant chance of becoming law. Too bad, for it contains some good ideas.**

Getty Images

FOUR hefty volumes filled with charts and statistics may not sound much like a novel. But judging by Washington's reaction, Mr Bush's 2008 budget, which was presented to Congress on February 5th, is more a work of fiction than fiscal policy.

The White House laid out $2.9 trillion of spending for the fiscal year that begins on October 1st. It promised to eliminate America's budget deficit by 2012 while making Mr Bush's tax cuts permanent and boosting cash for defence and homeland security. Other domestic spending would be squeezed. Mr Bush even proposed some cuts in Medicare, America's huge government health scheme for old people.

The plans were widely dismissed as being “dead on arrival”. Unlike parliamentary systems where government budgets are the blueprint for legislation, America's presidential budgets are never more than the opening gambit of a long legislative tussle. Congress's final tax and spending decisions often bear scant resemblance to the White House's requests. But even by those standards, Mr Bush's budget fell flat.

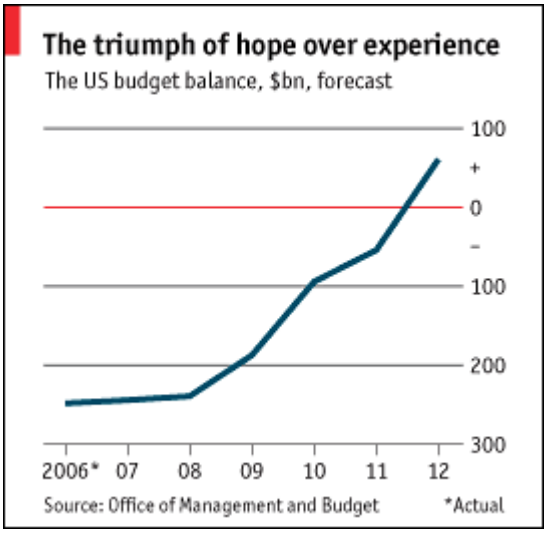
Some accused the White House of legerdemain. Kent Conrad, top Democrat on budget matters in the Senate, said it was “filled with debt and deception”. Many accused Mr Bush of ignoring the political change on Capitol Hill. Extending tax cuts and squeezing social spending will have little chance in the new Democratic-controlled Congress. Even Republicans were dismissive. “I don't think it has got a whole lot of legs,” said Judd Gregg, top Republican in the Senate budget committee.

Some of the criticisms are warranted. Mr Bush's promise to balance the budget by 2012 (see chart) depends on some unlikely assumptions, notably that the Alternative Minimum Tax will ensnare some 25m Americans after 2008 (up from 4m in 2006). His forecasts also include oddly rosy revenue projections, particularly after 2010. As economists from Goldman Sachs point out, the White House has slightly lowered its estimates for output in 2011 but has increased projected tax receipts.

In one important area, the costing of the war on terror, this budget is more honest than its predecessors. For the first time, Mr Bush has included a complete tally of spending in Iraq and Afghanistan this year ($163 billion), an estimate for 2008 ($145 billion) and a guess for 2009 ($50 billion).

The budget may not be a model of transparency, but much of Congress's harrumphing is disingenuous. Democrats complain

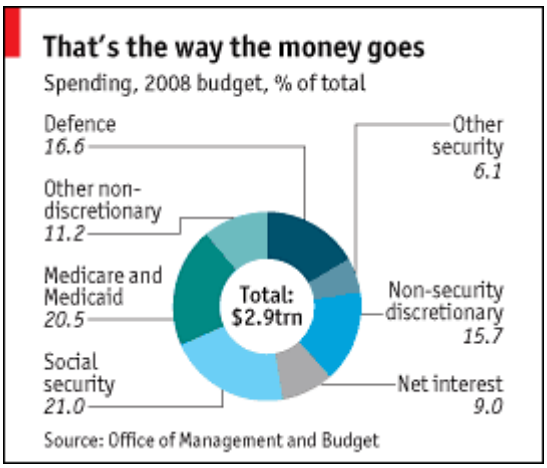
loudly about Mr Bush's focus on tax cuts. But beyond a (sensible) plan to create standard deductions for health insurance, which anyway should raise revenue over the medium term, Mr Bush's budget is mercifully free of new tax cuts. The budget does make the case for extending his existing tax cuts beyond 2010, the year in which, under current law, they all expire. But that argument is not pressing in this year's budget debate.




By the same token, Congress's decisions on domestic spending may end up closer to Mr Bush's budget than the current rhetoric suggests. Democrats have raised eyebrows over proposed increases in military spending—a 10% increase in the Pentagon's budget next year in addition to the money for Iraq and Afghanistan. They have promised to probe the figures carefully. But given the party's determination to avoid any blame for the Iraq mess, Congress seems unlikely to squeeze the defence budget hard.

Similarly, Democrats are determined to show voters that they are the more fiscally prudent party. That will limit their domestic spending ambitions. Some of Mr Bush's proposals, such as his plans to tighten eligibility criteria for SCHIP, the government health-scheme for children just above the poverty line, or to cut home heating oil subsidies for the poor, are sure to be loosened. But a spending bonanza is unlikely.

Where Mr Bush and Congress will differ most is in their appetite for attacking big entitlement schemes, particularly Medicare. The government health plan for the old and disabled is widely known to be the source of America's biggest long-term fiscal problem, thanks to an ageing population and rapidly rising medical costs.




Mr Bush's budget takes some useful snips at the behemoth. For instance, he wants to introduce some means-testing to the recent prescription-drug benefit and broaden the means-testing that already exists in the rest of Medicare. More affluent old people would pay higher premiums for their health-insurance coverage. Mr Bush also intends to trim payments to many medical providers by reducing the automatic inflation adjustment they get every year.

The immediate impact will not be huge. Overall, the Bush budget aims to slow entitlement spending by almost $100 billion over the next five years, with around half the savings coming from Medicare. But over the longer term the reforms would yield significant savings. The present value of Medicare's financial hole over the next 75 years is the astonishing sum of $32 trillion. The White House estimates that its plans would reduce that gap by some $8 trillion.

Since every politician in Washington knows that Medicare reform is essential, these proposals ought to be taken seriously. Yet they have been assailed from all sides. Fiscal hawks complain that the Medicare savings are much smaller than the cost of extending Mr Bush's tax cuts, a point that is true but irrelevant. Top Democrats cannot resist lambasting a budget that “cuts Medicare and Medicaid” while “sending more taxpayer dollars to Iraq”. Yet Congress shows no sign of coming up with its own ideas for Medicare reform. Dismissing Mr Bush's plans as fantasy is easier than dealing with fiscal reality.

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The politics of the Iraq war

# Showcasing disunity

Feb 8th 2007 | WASHINGTON, DC
From The Economist print edition

**American politicians are sounding more and more anti-war. It is still mostly talk, but talk matters**

TED KENNEDY is angry. “The cost in precious American lives is reason enough to end this mistaken and misguided war,” he told the Senate on February 6th. “But the cost at home here came into full view yesterday as we received the president's budget.” George Bush is asking for another $145 billion for the war on terror, most of it for Iraq and Afghanistan. “Where does the money come from?” asked the senator, his voice approaching a roar. It comes from children's health insurance, he said, from education and from heating-oil subsidies for the poor.

The Senate tried to debate Iraq this week. But since the chamber is split 51-49 between Democrats and Republicans and it takes 60 votes to break a filibuster, senators could not even agree on which bills to consider. Still, the House of Representatives is expected to tackle the same issue next week. In both chambers, nearly all Democrats and some Republicans want to express dismay at the way things are going in Iraq and opposition to “surge”, Mr Bush's plan to send 21,500 extra troops.

Congress controls the purse. The Democrats in charge could, in theory, end America's participation in the war in Iraq by refusing to pay for it. There is little chance they will do so, however, for then they would be blamed for the civil war that might follow. So for now, the only bills likely to pass either the House or the Senate will be non-binding, symbolic ones, and the dollars will keep flowing.

Mr Bush's latest request (to which must be added a supplementary $100 billion for the current fiscal year) would bring the total cost of the wars in Iraq and Afghanistan to $661 billion since 2001. That would make them a greater swallower of American treasure than the Vietnam war (in real dollars), though nowhere near as costly to America in terms of blood (3,100 deaths so far, versus 58,000). Total military spending for 2008 is projected at 4.4% of GDP. That is a lighter burden than during previous large conflicts: America spent more than 9% of GDP on defence at the height of the Vietnam war, 14% during the Korean war and 37% during the second world war.

It is not the money that worries Americans so much as the fear that the cause is hopeless. The average number of daily attacks by insurgents and militias in Iraq leapt from 75 at the beginning of last year to 185 in November. Two-fifths of the Iraqi professional class have fled the country. Even America's successes give little relief. Late last month, American and Iraqi troops smashed a Shia cult called the “Soldiers of Heaven”. A victory is a victory, but what struck viewers in Iowa was that Iraq has heavily-armed apocalyptic factions they have never even heard of.

A National Intelligence Estimate issued last week added to the gloom. Even if extra American troops can curb the violence, reconciliation looks unlikely, it said. On the other hand, were America to pull rapidly out, the situation would get much worse. The ensuing civil conflict would probably cause “massive civilian casualties” and perhaps prompt neighbouring states to intervene.

A sudden pull-out is unlikely, but an eventual withdrawal is all but certain. Ideally, this would happen after the surge restores a measure of peace and Iraqi politicians find a way to hold the country together.

Failing that, it may happen anyway. Democratic presidential candidates are sounding more anti-war than ever. Hillary Clinton promises that she will end the war if elected president. Barack Obama is proposing a bill to withdraw American troops by March 2008. John Edwards says it is “a betrayal” for Congress not to stop Mr Bush sending more troops now.

The war's remaining advocates worry that when American politicians sound so keen to abandon Iraq, Iraqis will believe them, and will arm for war once the Americans are gone. “For the Senate to take up a symbolic vote of no confidence on the eve of a decisive battle is unprecedented,” said Joe Lieberman, a Democratic-turned-independent senator. “But it is not inconsequential. It is an act which, I fear, will discourage our troops, hearten our enemies, and showcase our disunity.”

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Los Angeles' homeless

# On the skids

Feb 8th 2007 | LOS ANGELES
From The Economist print edition

**The police have cleaned up Skid Row. They have not got rid of it**

AP

**Moved on, but not housed**

"SEE the one sitting against the wall? He is close to death." By the time Andrew Bales has taken 100 steps down Gladys Avenue, he has pointed out a severely emaciated man, several heroin addicts and a prostitute plying her trade from a tent. Yet Mr Bales, who heads the Union Rescue Mission in Los Angeles, is in a cheerful mood. Such pockets of degradation now have to be deliberately sought out, he says. Before the police arrived, many of the 50-odd city blocks that comprise Skid Row were like Gladys Avenue.

Many American cities are ratcheting up their campaigns against homelessness. Federal pressure is one reason, but a bigger one is economic self-interest. An often-cited study followed 15 men around San Diego for a year and a half and found that they cost almost $100,000 each in hospital fees. Combine that with a yen to lure tourists and loft-dwellers to downtown districts, and the case for cleaning up the bad streets becomes overwhelming.

Los Angeles, which has more homeless than any other American city, has focused on the toughest spot. For the past five months a beefed-up police force has been arresting people for drug dealing and petty crimes such as littering in Skid Row, an area just east of downtown also known as Central City East. Missionaries accompany them, cajoling the homeless to join their drug-treatment programmes. The effect has been startling. According to the police, crime in downtown Los Angeles is now at 1940s levels. On February 1st some 800 people were counted on the streets of Skid Row. There were 1,900 in September.

Advocates for the homeless are furious at such heavy-handedness, but for the most part the cops seem to have picked on the right people. Skid Row veterans say that the number of genuinely needy folk in the area has diminished only slightly, which helps to explain why the shelters are still full almost every night. Most of the heroin and cigarette traffickers have pushed off, though. So have those who came to the area to buy and take drugs.

The trouble is that part of the problem has moved elsewhere. Politicians in other parts of Los Angeles complain that they are seeing more homeless people. Breaking up big encampments such as Skid Row is no bad thing: they are so lawless that they can quickly turn mildly-troubled people into serious cases. Still, Skid Row has plenty of shelters. The areas where the homeless are going may not.

Cities that have managed to reduce the overall level of homelessness over a period of several years, such as New York and San Francisco, have built lots of temporary assisted-housing where people can be taught more orderly habits. Los Angeles has been slow to follow. The political will is lacking—Skid Row may be horrific, but it is hidden in a warehouse district where few Angelenos venture. The patchwork nature of Los Angeles' city and county governments doesn't help either.

Philip Mangano, who heads the federal Interagency Council on Homelessness, tells a story about visiting Los Angeles during an earlier, smaller crackdown. The mayor had boasted that hundreds of homeless people had left Skid Row, but Mr Mangano soon found them cowering under a freeway entrance ramp. They eventually returned to the streets—something that could happen again. Remove the extra police, says Mr Bales, and the area will be back to normal within a week.

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Reviving Newark

# The phoenix of New Jersey?

Feb 8th 2007 | NEWARK
From The Economist print edition

**The mayor has a practical vision for a long-neglected city**

AP

CORY BOOKER, elected mayor last summer, is trying to revive his neglected Newark, and about time too. Newark is one of America's poorest cities, with over a quarter of its people living in poverty. Unemployment is high and violent crime common. Over half of pupils drop out of high school. But the city also has some things going for it. It is only eight miles from New York, it has a busy port, a bustling airport and a top-notch transit system for would-be commuters. It has a few good universities. Companies as well as ordinary people priced out of Manhattan are beginning to discover Newark.

The city has long been synonymous with urban decay. Mismanaged government was the norm. Two former mayors have been convicted: one spent time in jail. Sharpe James, the mayor before Mr Booker, is no angel either. Federal agents are investigating his financial dealings: he racked up over $150,000 on two city-issued credit cards during his last two years in office. Trips to Rio de Janeiro, the Dominican Republic, Florida, Puerto Rico and Martha's Vineyard are being looked into. And it appears that some of his top aides may have profited from the sale of city property for below-market prices.

Mr Booker is proposing a sweeping package of ethics legislation, though he admits much of his time is spent on damage control. He inherited a fiscal nightmare. Mr James boasted of a $30m surplus before he left office and promised a 5% cut in property taxes. State auditors then discovered there was no surplus, but instead a $44m deficit. So Mr Booker had little choice but to raise property taxes almost immediately. He still delivered Newark's budget on time on January 12th, a first in almost 20 years.

Mr Booker is overseeing a lot of firsts. One of his top priorities is to make crime-ridden Newark safe so he can attract more residents and jobs. Last month he and Garry McCarthy, his police director, unveiled a new crime initiative. For the first time, Newark will have a centralised intelligence-gathering narcotics division. Drugs have been openly sold on city streets for decades, but fears of police corruption prevented a programme before now.

Guns are cheap and plentiful and even available to rent by the day. Mr Booker recently joined the Mayors Against Illegal Guns coalition, formed by Michael Bloomberg, New York's crime-fighting mayor, to help get them off the streets. A video surveillance programme, with gunshot detection technology, will soon be ready. Still, the year is barely a month old and the murder count in Newark, a city of 280,000, is already at 12. The 2006 death toll of 104 was the highest in over a decade. The murders are overshadowing the progress being made to make Newark a safer city, but overall crime is down 35%. Shootings, robberies and car thefts experienced double-digit drops.

Mr Booker is also working on Newark's long-term growth and development. He is trying to rationalise the archaic city zoning rules by creating a new Planning Department. He is talking to national retailers about opening branches in Newark, long ignored by major chains and department stores. There's a long way to go: but at last something seems to be happening.

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**Shooting wolves**

# In danger again

Feb 8th 2007 | SHERIDAN, WYOMING
From The Economist print edition

**The grey wolf may soon be hunted again**

IN THE last week of January, a female grey wolf stepped into a steel leg-hold trap on a ranch outside LaBarge, Wyoming. It was set for a coyote. Old, teeth worn down to the gum, the wolf had enough strength to uproot the trap from its anchor. She was hardly free, however: she took the trap and its chain with her, and within a few days, a US Fish & Wildlife Service wolf specialist had tracked the injured wolf down and, out of compassion, shot her.

This is a fairly common event. Various wildlife agencies shot 152 wolves last year. But now, the grey wolf may be about to die in much greater numbers. Within days of the female wolf's demise, the Fish & Wildlife Service proposed booting the grey wolf off the endangered-species list throughout the northern Rockies, and did delist them in the western Great Lakes area. Grey wolves have been protected in almost all of America since 1974, when it was feared they were headed for extinction.

The justification is that wolves are far more abundant than they used to be. Back in 1995 and 1996, a group of 32 wolves were introduced into Yellowstone National Park and 35 into Idaho: now, roughly 370 wolves roam in the contiguous area of Idaho, Wyoming and Montana. Add in wolves drifting from Canada into Montana, and the total number in the northern Rockies is around 1,250.

But all these wolves need food. Elk make up about 90% of wolves' diet in the greater Yellowstone region. That is fine for the overgrazed park, say hunters, but what about the very obvious decrease in elk herds in the surrounding states? Ranchers are also unhappy. In 2006 wolves in the Rockies killed 170 cows, 344 sheep, eight dogs, a horse, a mule and two llamas.

The Fish & Wildlife Service has already approved wolf management plans from Idaho and Montana—much to the glee of Idaho's governor, Butch Otter, who declared that he is “prepared to bid for that first ticket to shoot a wolf myself.” The service is still waiting for a sustainable management plan from Wyoming. But once it has that, wolves may once again be fair game for hunters.

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Environment awareness

# No child left inside

Feb 8th 2007 | SAN FRANCISCO
From The Economist print edition

**Put down that Xbox, young man**

TO THE alarm of environmentalists and park managers alike, interest in the great outdoors seems to be tailing off among young Americans. The country's extensive system of national parks includes some of the most photographed and best preserved landscapes on earth—like Yosemite Valley in California, the crenellated Teton Range in Wyoming, Old Faithful geyser in Yellowstone National Park or the white edifice of Mount Rainier in Washington state. But attendance at the parks is falling. Between 1995 and 2005, overnight stays in them declined 20% overall, and camping and backcountry stays dropped by 24%, according to statistics compiled by the National Parks Service.

No park, it seems, is immune to the decline: even in Yosemite, one of the system's oldest parks and probably its best known, the number of visitors dropped 17% over the ten-year period. The number of visitors to Death Valley, an easy drive from vigorously growing Las Vegas, went down 28% over the same span. In some of the system's remoter parks, such as Lava Beds National Monument near the California-Oregon border, site of much fighting in an Indian war of 1872-73, the number of daily visitors is down to ten or fewer.

The importance of this decline can hardly be over-estimated for big environmental organisations such as the Sierra Club: they have depended on what one expert calls “a transcendent experience in nature”, usually in childhood, to gain new members and thus remain powerful lobbyists for environmental causes. “The political implications are enormous,” says Richard Louv, a writer whose most recent book, “Last Child in the Woods: Saving Our Children from Nature-Deficit Disorder”, describes the social, psychological and even spiritual ramifications of a dearth of outdoors experience for a generation raised on electronic, rather than natural, stimulation and entertainment.

To encourage environmental interest in young people, particularly non-whites who are much less like to visit parks than whites are, Martin LeBlanc at the Sierra Club manages 65 volunteer-led programmes around the country to bring inner-city children into direct experience with the natural world. “We don‘t need to be giving them propaganda about offshore oil-drilling, not when they're 13 years old,” he said. “We just need to get them outside.”

For its part, the National Wildlife Federation (NWF) has had its “Ranger Rick” magazine and education programme for children in place for 40 years, but Kevin Coyle, the group's vice-president for education, thinks that the declining interest in the outdoors has spurred a feeling of urgency among environmentalists. “There won't be a conservation movement 30 years from now if there's no love for nature,” he says.

The NWF has created a new “green hour a day” programme to encourage families to spend at least an hour a day outside; a website with green-hour activities will go live in March. The group has also joined with traditional hunting and sportsmen's organisations, which are also experiencing declining membership and interest, to lobby state governments for more outdoor-education funding.

Mr Louv, the writer, has been busy as well, helping local, state and national groups bring America's children outdoors under a campaign he calls “No Child Left Inside”. He is pleased by the idea's wide appeal. “This issue has the power to pull people together from sectors you wouldn't expect. Environmentalists are traditionally liberal, but conservatives, too, are worried about children and nature,” he said. “It's a grass-roots movement in both the literal and metaphoric senses”.

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Health care

# God, sex, drugs and politics

Feb 8th 2007 | NEW YORK
From The Economist print edition

**A new vaccine sparks controversy**

“THE governor's action seems to signify that God's moral law regarding sex outside of marriage can be transgressed without consequence.” Those words came this week from Rick Scarborough of Vision America, a Christian lobbying group. The US Pastor Council and various Republican politicians have piled in too.

Usually, this sort of right-wing animosity is reserved for the likes of Hillary Clinton, but this week's attack was on one of the Christian right's favourite sons: Rick Perry, the deeply religious Republican governor of Texas. His offence? Promoting the use of a highly effective new vaccine that is sure to save many women from a nasty form of cancer. But to some people, it is tantamount to encouraging promiscuity.

On February 2nd Mr Perry bypassed the state legislature and mandated vaccination against the human papilloma virus (HPV). His order would affect all girls entering sixth grade (at about 11) unless their parents opt out in writing. Perhaps 20m Americans carry this virus, making it one of the most common sexually transmitted diseases in the country. Most strains are harmless, but a few can lead to cervical cancer, the second most deadly form of cancer in women.

Merck, a drugs giant, won federal approval for its HPV vaccine last year and has been lobbying for its adoption. California, South Dakota, New Hampshire and other states now make it available. Virginia, Maryland and the District of Columbia are considering the matter, while Washington state this week announced a voluntary scheme. But no state has mandated its use until now.

Why did Mr Perry do it? Some sneerers have noted that his former chief of staff is now a lobbyist for Merck. Others think that the wily governor is distancing himself from his conservative base so that he can make a plausible vice-presidential candidate in 2008. But there is another explanation: that he had the courage to make a politically difficult but sound policy decision. As he said this week: “If the medical community developed a vaccine for lung cancer,” he asked, “would the same critics oppose it, claiming it would encourage smoking?”

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**Visa policy**

# Keeping out more than terrorists

Feb 8th 2007 | NEW YORK
From The Economist print edition

**Disquiet is growing over restrictions on foreign visitors**

“ON THE boats and on the planes/ They're coming to America/ Never looking back again/ They're coming to America.” Neil Diamond might want to rethink the lyrics of his 1980 hit in light of recent developments. The number of overseas visitors to the United States (ie, excluding Canadians and Mexicans) has fallen by 17% since 2000. Last year, arrivals from western Europe dropped by 3%, despite the attractions of a weaker dollar and a record-breaking year for world tourism.

The travel industry blames a tortuous visa process and a perception of poor treatment on entering the country. In a survey late last year, America scored more than twice as badly as the next region (the Middle East) on traveller friendliness. Respondents said they feared immigration officials more than terrorists. New York worries that extra security measures since 2001 are making it less competitive as a financial centre. American companies are holding more meetings abroad. Universities are moaning too. The “travel crisis” is even cited as a factor in the loss of the 2007 Pan American Games to Brazil.

That sort of thing goes down badly with politicians, and they are queuing up to propose fixes. Congressional hearings were held last week. Byron Dorgan, the North Dakota Democrat who chairs the Senate's tourism subcommittee, says new legislation is needed. A bill is expected this year and will probably borrow elements from the “Blueprint for Change” drawn up recently by the Discover America Partnership, a travel-industry lobby group, with help from Tom Ridge, America's first homeland-security chief.

The document calls for the hiring of more consular staff to bring visa-processing times down from three months or more in some countries to below 30 days, and for rapid-response teams when waiting times spiral—a team sent to India last year cut the backlog from six months to just over a week in a few days. It proposes extending visa-waiver rights to more countries—only 27 now have them—in return for more information on travellers. And it suggests ending the requirement that all visa applicants attend an interview at a consular office, a huge inconvenience.

The other plank of the proposal is sprucing up service at airports. Geoff Freeman, Discover America's executive director, says the real problem at airports, as with embassies, is lack of people. At half of the 20 busiest, he estimates, the customs service is understaffed by 20% or more. Management of queues is chaotic. Disney, which knows a thing or two about line management, has offered to help. Its advances have been spurned.

The State Department insists that things are getting better. Foreign scientists offered jobs in America no longer have to wait several months for clearance, 12% more business visas were issued last year than in 2005, and the annual number of student visas has stabilised. But it will take bigger smiles and smaller queues to win back all those travellers who have decided that it is a lot less hassle to go elsewhere.

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Lexington

# Rudy rising

Feb 8th 2007
From The Economist print edition

**Can America's most famous mayor become the Republican Party's champion?**

Kevin Kallaugher

ON FEBRUARY 5th, Rudy Giuliani sort-of-almost declared that he is running for the Republican nomination, filing a “statement of candidacy”. It's a shame these people can't just spit it out; but the “statement” solidified Mr Giuliani's position as the Republican front-runner, an average of five points ahead of his nearest rival, John McCain, in the polls. It also set off a firestorm between different conservative factions—with pro-Giuliani forces praising him for being tough on crime and terrorism and social conservatives accusing him of “defacing the institution that forms the foundation of human civilisation”, as Terry Jeffrey, an editor-at-large at *Human Events*, put it.

Social conservatives are a big problem for Mr Giuliani. He is the most socially liberal senior Republican since Gerald Ford, in a party that has moved relentlessly to the right on social issues since Ford's day. Tony Perkins, the head of the evangelical Family Research Council, pronounces his candidacy “unacceptable”. Mr Giuliani is pro-choice and anti-gun, pro-civil unions and anti-moral censoriousness. He is on his third marriage; he once lived with two gay men and a chihuahua, and dressed up as Marilyn Monroe for a comedy sketch. This may go down well in Gotham. But will it play in Peoria? A Democratic strategist quips that it is rather like their party fielding a segregationist.

The polling evidence suggests that Mr Giuliani's views could be a problem for rank-and-file Republicans as well as professional culture warriors. A recent *USA Today*/Gallup poll found that barely one in five Republicans knew that he supported abortion choice and civil unions for gay couples. One in five Republicans, when informed of this, said that those views put supporting him out of the question.

But is the problem insuperable? Mr Giuliani has three big things going for him. He was a highly successful mayor of New York, precisely because he grabbed hold of a monument to liberalism-gone-wild—with a bloated bureaucracy, an institutionalised underclass and a soaring crime rate—and reformed it by applying solidly conservative principles. As Steven Malanga of the Manhattan Institute points out, he put law and order above everything else (instituting a “zero tolerance” approach to petty crime, for instance); tried to unleash the private sector (including abolishing or cutting 23 taxes); and took on vested interests, from teachers' unions to the welfare bureaucracy. The result was an urban revolution: the murder rate fell by 67%, tourists returned and the private sector boomed.

In fact, Mr Giuliani can boast a solidly conservative record on all sorts of things that matter to the base. He served in the Reagan administration's Justice Department along with John Roberts, George Bush's appointee as chief justice of the Supreme Court. He was an aggressive special prosecutor. He trimmed affirmative action, effectively ended racial quotas at the City University of New York and championed school choice.

His second big plus is that most Americans—including most social conservatives—view Mr Giuliani above all as the hero of September 11th 2001. Mr Giuliani became “America's mayor” that day because his decisiveness contrasted with the administration's dithering: he rushed downtown as soon as the first aeroplane hit and took command amid the confusion. Mr Giuliani's halo has not faded since in the way that Mr Bush's has.

His third advantage is that the religious right is in the doldrums. Last November, as the socially liberal Arnold Schwarzenegger stormed to re-election in California, social conservatives bombed. Rick Santorum barely scraped 40% of the vote in the Senate race for Pennsylvania, a dreadful result for a two-term senator. And conservatives lost a series of ballot initiatives—on abortion in South Dakota and California, stem-cell research in Missouri and gay marriage in Arizona.

## What's the alternative?

It is unclear who social conservatives would rally around if they wanted to kneecap the front-runner. John McCain? Many of them dislike him almost as much as Mr Giuliani. Mitt Romney? A Mormon who has flip-flopped on both abortion and civil unions, and said he was “effectively pro-choice” as recently as two years ago. Mike Huckabee? A man with no national standing, who has recently been savaged by the conservative Club for Growth for raising taxes and spending as governor of Arkansas. Sam Brownback? His candidacy would probably hand the Democrats a lock on all three branches of government.

Mr Giuliani will clearly have a difficult time with his party's diehards. He will also face other problems. He is an abrasive New Yorker in a country that tends to elect hail-fellow-well-met types like Ronald Reagan and Bill Clinton. He also has a goodly number of skeletons in his closet besides his liberal social views: he was a close friend of Bernard Kerik, a former New York City police commissioner whose nomination for the position of secretary for homeland security was laughed out of court amid allegations about an illegal nanny, questionable business dealings and extra-marital affairs.

But he can still make a good fist of it. He already has a lot of conservative fans—his performance on the Fox News channel this week went down like a dream—and he has the stuff to win over many more. It means a bit of backsliding: he will have to revise his position on guns if he is to succeed in the West and the South. But in general it means trumpeting his strengths. He needs to persuade people that his conservative credentials on crime and terrorism trump his heretical views on other issues. And he needs to point out that he has the best chance of keeping Hillary Clinton out of the White House. He tops almost all the polls; and as Republicans make up their minds over the next year, they may end up paying more attention to such numbers than to the dead-end rhetoric of Mr Jeffrey and Mr Perkins.

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Haiti

# Building a reluctant nation

Feb 8th 2007 | PORT-AU-PRINCE
From The Economist print edition

Eyevine

**René Préval (pictured below) and the UN have made modest progress but have yet to turn Haiti into a viable country**

Get article background

THE United Nations is rebuilding a house. A couple of soldiers mix cement on the street, lifting it up by a backhoe to their colleagues who use it as mortar, placing concrete block on top of concrete block. The house is tiny, and cramped inside; there is barely room for the gun emplacements that face every which way from the second storey, pointing out over sandbags which are being replaced by the concrete blocks.

It is the newest outpost of the United Nations Stabilisation Mission in Haiti (known as MINUSTAH from its initials in French). Brazilian troops under the command of Colonel Cláudio Barroso Magno took over the house in a 2am raid in late January. It was part of an effort by UN troops, begun a month earlier, to set up strongpoints in Cité Soleil, a slum district of Haiti's capital which has been under the control of criminal gangs for years.

This tenuous foothold of law and order is a microcosm of Haiti's snail-like progress a year after René Préval was elected as president of the poorest and most lawless country of the Americas. The election came two years after the ousting of the thuggish socialist regime of Jean-Bertrand Aristide at the hands of a rebel band and American and French troops.

For a failing state, the election was a success. Mr Préval, a moderate former president who was once an ally of Mr Aristide, won just over 50% of the vote. But he did not form a government until June, after legislative elections. Local elections followed in December, with more due in March. All this voting gives Haitians the chance of a fresh start, but it has also diverted resources from other priorities.

The most pressing issue remains crime. The government tried at first to negotiate with the criminal gangs. But kidnaps, assaults and drug-trafficking rose. A UN scheme under which those who hand in guns get job training has few takers. The new, tougher policy is aimed at regaining control of places like Cité Soleil, a district of more than 200,000 people which has been too dangerous for aid groups to enter.

The new UN presence there is meant in part to get the gangs to react, says Colonel Magno. In that, at least, it is working. There are nightly attacks on the strongpoints; the concrete blocks are pockmarked with bullet scars. It may also be having a wider effect: January saw only a third as many kidnappings as December, according to MINUSTAH. “We can end kidnapping” by the summer, says Colonel Magno.

This modest progress underlines that the UN force of 6,700 soldiers and 1,700 police—mainly from Latin

America but including troops from Jordan and Nepal and police from China—will be needed for a long while yet. The government is rebuilding a national police force, but it is slow work. The police number only about 6,000 for a rugged country of 8.5m people. Another 500 or so are graduating every six months from the police academy run by the UN. The new police have been vetted in an effort to avoid the corruption of the country's past gendarmeries.

But the whole judicial system also needs reform. According to International Crisis Group, a Brussels-based organisation, 96% of the inmates of the main national prison have not been tried. Past efforts by international donors to achieve judicial reform failed. Now parliament is discussing, without urgency, plans to vet judges and increase their salaries, currently $200-500 a month.

Mr Préval's main achievement has been to get the budget approved in the legislature. His party, itself a makeshift coalition, has only a fifth of the seats in the lower house and a third in the upper. The main obstacle is not partisanship, but individualism. Legislators spent several of the past few weeks trying to get a policeman sacked for inspecting a congressman's car (he found illegal weapons).

Even in Port-au-Prince's richer suburbs, rubbish fills the streets. The economy has stopped contracting. Venezuela supplies subsidised oil and Haitians in the United States send money home. But Haiti still depends on foreign aid for over 65% of the state budget. A job-creation scheme, backed by $128m from the United States and the World Bank, is only just starting up. According to the bank, 83% of skilled Haitians live abroad. Driven out by instability and poverty, they have yet to show any sign of returning.

The motto of Colonel Magno's brigade is: “To be more than it seems”. That is Mr Préval's task, too, if Haiti is to become a functioning nation-state. Enough has been achieved to warrant staying the course. But the burden will increasingly be on Mr Préval to produce results.

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Brazil

# Parliament or pigsty?

Feb 8th 2007 | RIO DE JANEIRO
From The Economist print edition

**A failed campaign to clean up a tarnished legislature**

IT MAY be one of the world's largest and most unruly legislatures, but presiding over the lower chamber of Brazil's Congress is a powerful and much-prized job. On February 1st, after a bitter campaign, in which three candidates variously invoked the heroes of Brazilian independence, famous abolitionists and Moses, the post went to Arlindo Chinaglia, a congressmen from the ruling Workers' Party (PT). History, having been invoked, will judge him on whether he restores the institution's reputation, which is at rock bottom.

A recent opinion poll commissioned for *Veja*, Brazil's biggest newsweekly, found that most respondents regarded their national legislators as underworked, self-serving, and dishonest. Nearly half of those polled called them liars while two in five said that democracy would be better off without Congress. “This generation of politicians is lamentable,” says Bolívar Lamounier, a political scientist in São Paulo. “Not long ago, you could find maybe 20 parliamentary leaders of national stature. Today you'd be lucky to find two.”

Part of the problem is the fragmentation of Brazilian politics. No fewer than 21 political parties are represented in the 513-seat chamber, up from 19 last time. But only seven of these have a national presence, the rest being flags of convenience. More than a fifth of the last Congress switched parties, usually in return for favours, some of them half-a-dozen times. The difficulty of assembling a majority ensnared the government of President Luiz Inácio Lula da Silva in a succession of scandals in the previous legislature.

Those scandals toppled several of Lula's closest aides, including José Dirceu, his former chief of staff. According to Brazil's attorney-general, Mr Dirceu ran “a sophisticated criminal organisation” to buy votes in Congress.

And yet voters seemed unmoved. Though it took an unexpected run-off vote, Lula won a second four-year term last October. While nearly half the old Congress was turned out, a dozen government supporters caught out in misdeeds remain in the legislature. They include João Paulo Cunha of the Workers' Party, whose wife took 50,000 reais ($24,000) in off-the-books payments from a political moneyman. Mr Chinaglia is close to Mr Dirceu, who hopes to persuade Congress to pardon him and restore his right to run for office. “Congressional inquests are important for exposing the facts, but not enough to convict the culprits,” says Mr Lamounier. “People get weary of scandals.”

Lula's response was to promise political reform. But that is asking turkeys to vote for Christmas. It takes a more determined president than Lula to pilot unpopular measures through a legislature where laws stand or fall on the whims of special interests, regional claques and a voracious demand for pork and patronage. For day-to-day business, governments rely on “provisional measures”. These are decrees by another name. They can be rejected by Congress, but in practice it tends to rubber-stamp them.

For a brief moment, it looked as if the new Congress might see a serious clean-up. Piqued by an attempt by lawmakers to almost double their salaries, a cross-party group of legislators launched an independent candidate for president of the lower house. Gustavo Fruet, a youngish member of the opposition Party of Brazilian Social Democracy, promised to “moralise” Congress by cutting (and making public) the amount legislators spend on themselves.

The uprising failed. In a secret ballot, Mr Chinaglia won by 18 votes, many of them it seems cast by Mr Fruet's own party on the unspoken understanding that the PT would cede it the post of deputy leader in Congress and the upper hand in the São Paulo state legislature. Parochial back-scratching trumped ethics. “We never thought we could win,” says Fernando Gabeira, one of the congressional rebels. “But

bringing public pressure is important to keep Congress transparent and honest."

Mr Chinaglia won partly by vowing to defend Congress against its detractors. "Whoever attacks parliament...also attacks democracy," he intoned. The more difficult task is to protect Brazilian democracy from itself.

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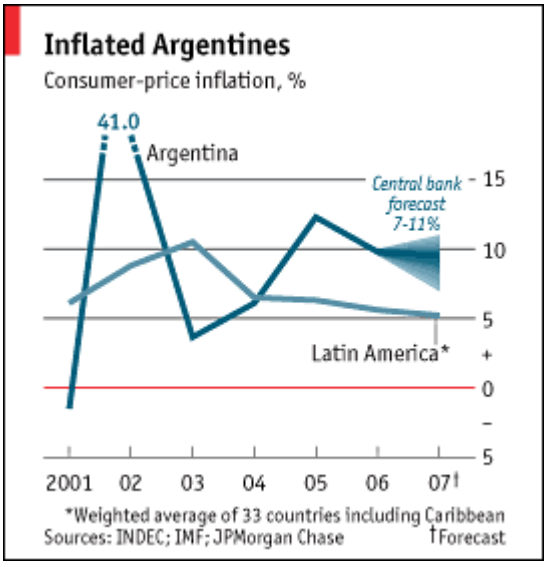
Argentina

# Cooking the books

Feb 8th 2007 | BUENOS AIRES
From The Economist print edition

**The government massages bad news**




WHEN a dash for economic growth produces double-digit inflation, most governments change their policies. But not that of Argentina: it has opted to keep the policies and change the inflation numbers. Last month, it sacked the head of the consumer-prices section of the National Statistics and Census Institute (INDEC), replacing her with Beatriz Paglieri, a trade specialist at the economy ministry. Five days later the institute announced that January's inflation was 1.1%. Private economists estimate that the real figure was between 1.5% and 2%.

This crude statistical jiggery-pokery suggests that officials reckon that inflation might be the only obstacle preventing Néstor Kirchner from winning a second term in a presidential election in October (though his wife may stand in his stead). After collapsing in 2001-02, the economy has notched up four years of growth of 9%. It has shown clear signs of overheating (see chart). The government's response was price-freezing "agreements" with many businesses. But prices are still rising.

Ms Paglieri has the confidence of Guillermo Moreno, the secretary of internal trade and the government's chief price enforcer. To arrive at the 1.1% figure for January, she apparently changed the institute's methodology. It dropped from the index prepaid annual health-insurance policies, which come up for renewal in January and whose average cost rose by 22% over the past year. It also changed its sample of tourism companies, reporting that holiday costs had risen by only 3.7% in January, compared with 16.7% in the same month last year. According to an economist who formerly worked at the institute, between them these two changes reduced the inflation rate by 0.8 of a percentage point.

Officials may have had an eye on annual salary negotiations between unions and employers, which start this month. But "unions read the newspapers too, and the perception that people have of inflation is very different from the index," says Javier González Fraga, a former central-bank president.

Argentina is still a long way from a return of the hyperinflation of the 1970s and 1980s. But many economists believe that prices of goods and services not covered by price controls will rise by 13-15% this year. Nipping inflation in the bud would require a rise in interest rates and curbs on public spending, as well as letting the peso appreciate. But first there is an election to be fought. It is shaping up to be a war of numbers.

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Peru

# Sweet times

Feb 8th 2007 | CHICLAYO
From The Economist print edition

**Privatisation heralds a sugar boom**

IN THE 1960s, Peru's sugar industry was among the most efficient in the world. It was all downhill thereafter. A military government expropriated the sugar estates on the country's north coast, turning them into government-owned co-operatives. Having peaked at 1m tonnes in 1975, output fell to 400,000 tonnes by the early 1990s. But since then the sugar industry has passed into private hands again. Over the past decade production has returned to its historic peak—and is now set to boom.

The change has been gradual. The government has sold its stake in the industry in tranches. But now investors are piling in. As in other parts of South and Central America they are attracted by higher prices for sugar because of its use for ethanol. Industry sources predict that land under sugar will expand by 10,000 hectares (25,000 acres) a year, more than doubling output over the next decade. That would turn Peru into an exporter—though not on the scale of Brazil or Colombia.

Last year, local investors secured a controlling stake in Casa Grande, the largest sugar plantation. Bioterra, a Spanish company, plans a $90m ethanol plant nearby. Maple, a Texas company, has bought 10,600 hectares of land in the northern department of Piura. Its plans call for an investment of $120m and ethanol production of 120m litres a year. Brazilian and Ecuadorean investors are also active.

Part of the attraction is that Peru has signed a free-trade agreement with the United States. Provided that it can satisfy the concerns of the new Democratic-controlled Congress in Washington, DC, about the enforcement of labour rights, this agreement should be approved later this year. It would render permanent existing trade preferences under which ethanol from Peru can enter the United States duty-free. By contrast, ethanol exported from Brazil, the world's biggest producer, must pay a tariff of 54 cents a gallon.

Two harsh realities might sour these sweet dreams. Colombia, Central America and the Dominican Republic all enjoy similar preferences and have similar plans. Colombia already produces 360m litres a year of ethanol, much of it for export. The second question is whether sugar—a thirsty crop—is the best use of Peru's desert coastal strip, with its precarious water supply. One of the country's achievements of the past decade has been the private sector's development of new export crops. It would be ironic if these businesses were threatened by sugar's privatisation.

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Paraguay

# The next Chávez?

Feb 8th 2007 | ASUNCIÓN
From The Economist print edition

## A would-be political messiah

Reuters

**Lugo swaps mitre for something lighter**

FOR 60 years, first in dictatorship and since 1989 in democracy, Paraguay has been governed by the Colorado Party. That may soon change—at least if a rebellious former Catholic bishop has his way. The presidential election is not until April 2008. But Father Fernando Lugo has already become the most popular candidate of a diverse opposition. He is an admirer of Venezuela's socialist president, Hugo Chávez, and of Bolivia's Evo Morales.

Like neighbouring Bolivia, Paraguay is landlocked and poor. Though most Paraguayans are *mestizos* (of mixed race), most speak Guaraní as well as Spanish. As bishop of San Pedro, one of the poorest parts of Paraguay, for 11 years Father Lugo worked closely with peasant movements agitating for land reform. That is a pressing need in a country where more than two-fifths of the population of 6m still live in rural areas, and where land ownership is very unequal. Last year, he attracted some 50,000 people to a rally against corruption. Ordinary Paraguayans greet him in the street, as if he were a rock star.

Because of his political activities in San Pedro, where the threat of takeovers of commercial farms sparked tensions, the Catholic hierarchy stepped in and obliged Father Lugo to step down as bishop. In December, he resigned as a priest in order to enter politics. The church has not so far accepted his resignation. Nevertheless, he has founded a political movement called *Teko joja* ("justice and equality" in Guaraní).

Many of Father Lugo's supporters come from the left. But he has attracted the backing of Patria Querida, a larger party founded by a conservative Catholic businessman. He says he wants to apply Christian charity to politics and dreams of "a different country, of equality, without discrimination."

After decades of corrupt misrule by the Colorados, the current president, Nicanor Duarte, has taken steps to reform the country. He has also sought the friendship of the United States, partly to offset the powerful influence of Brazil. But under the constitution, Mr Duarte cannot seek a second term.

Since that document also bans priests from standing, the president has offered to negotiate a constitutional amendment that would allow both him and Father Lugo to run. In a country where politics is such a tainted profession, Paraguayans may flock to the man who promises to cleanse the temple. But whether he is a democratic reformer or a demagogic populist remains to be seen.

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Bangladesh

# Everybody but the politicians is happy

Feb 8th 2007 | DHAKA AND SHIRAJGANJ
From The Economist print edition

**The new military-backed government has sensible ideas for tackling Bangladesh's problems but the worst of these problems, the two begums, are not for quitting**

AP

Get article background

WHEN Bangladesh's army seized power last month, no one at first seemed to notice. On January 11th, the generals ordered President Iajuddin Ahmed to declare a state of emergency to forestall a rigged and violent election due on January 22nd. Basic rights were suspended and a technocratic caretaker government appointed. Some 40,000 low-level gangsters and political thugs have since been detained—though that is only a third more than in an average month in Bangladesh. No tanks have lumbered onto Dhaka's choked streets. No local politician or foreign government has kicked up a fuss.

This week, however, the army bared its teeth. On successive nights it arrested two dozen much grander suspects. All are senior members or accomplices of the two political parties that have looted and misruled Bangladesh, one of the world's most corrupt countries, for the 16 years since its last military government. More arrests are promised. Senior officers say they have drafted a list of 420 top-level targets, including much of the last parliament. Under the emergency laws, detainees can, in effect, be held indefinitely. Another draconian measure, to make forfeit the property of any suspect who evades arrest for 72 hours, awaits the president's signature.

A convenient tool for processing this round-up is in place: the “speedy-trial tribunals” designed by the government led by Khaleda Zia's Bangladesh Nationalist Party (BNP), which ran the country until the end of last year. The purpose of these tribunals was to try serious crimes within 90 days—but corruption, the BNP said at the time, would not be among such crimes. The army says otherwise and has formed teams of military and civilian investigators for the task. It believes they can find most of the evidence needed to convict the suspects within the given time.

Dhaka is in an excited state, with a few hundred politicians and businessmen fearing arrest, and almost everyone else delighted by the prospect. To start the week, your correspondent's first scheduled interviewee had been arrested overnight; his second expressed a desire to go home and pack a suitcase (“I need a mosquito net, there are too many mosquitoes in prison”); his host for the evening then called to say that his four guests of honour were in the clink.

The detainees are mostly from an elite group that has prospered whichever of Bangladesh's two main parties has been in power, with friends in both camps. They also include confidants of the parties' leaders, Mrs Zia and Sheikh Hasina Wajed of the Awami League (AL). The autocratic habits and mutual loathing of

these two women are the main cause of the mess. One prisoner, Mosaddeq Hossain Falu, who began as Mrs Zia's factotum, progressed to become a member of parliament and proud owner of two television stations, a newspaper and a bank. With trademark moustaches and grin, he campaigned as the “always smiling Mr Falu”.

Non-politicos, including employees of NGOs, of which there are more than in any other country, and many of Bangladesh's unusually politically alert poor, are rejoicing at the politicians' downfall. Moreover, the administration—in the way of military, or military-backed, governments—is promising a slew of other good things.

For a start, it vows to depoliticise the institutions. It has appointed a new electoral commission and forced out the bosses of the anti-corruption authority. It promises to fix a chronic power shortage, and on January 31st approved a deal with an Indian firm to build a 240MW power station. On February 3rd it announced plans to make the state banks more accountable, a step the politicians and their cronies, who have bust the banks by extracting and defaulting on massive loans, had resisted. Such measures, the administration says, are necessary precursors to fair elections. It has not said when an election might be.

This sets the government apart: most military-backed regimes announce a proximate election date, then let it pass. And it has issued other ambiguous signals. On January 25th it announced a clamp on the media—but promised not to implement it after newspaper editors objected.

It also bulldozed thousands of illegal slum-dwellings, but then eased off on the advice that hammering poor Bangladeshis, about 40% of the population, would not make it popular. Beside a railway line in Dhaka, a group of such women plucked chicken skins on the scrap of wasteland that passes for a public lavatory and the site of their illegal homes. They scavenge the skins from a nearby market, one explained, then sell them plucked for a few cents. Since the army took charge, they have dismantled their cardboard shacks each morning and rebuilt them at night.

Although the army is stepping carefully, it is unlikely to allow elections for at least a year. Correcting the BNP's fraudulent electoral roll, including 12.2m dubious names, according to the National Democratic Institute, will take several months. No one wants to vote during the monsoon-flooded summer. Less understandably, the administration says it needs to issue fraud-proof identity cards, which could take a year. Some of its supporters say they want a unity government, perhaps led by Muhammad Yunus, the winner of this year's Nobel peace prize. Such measures indicate that the army would quite like an extended rule, albeit behind a curtain.

## The loathing of the begums

However long the pause, Bangladesh's democracy is probably unreformable, from without or within, while Mrs Zia and Sheikh Hasina, known as “the two begums”, still rule their roosts. Bangladeshi politics are vicious, a fight for state patronage made desperate by the knowledge that none of the loot will be shared. Battles between stave-wielding followers of the two parties have marred each election since 1991, when democracy was restored after countrywide protests forced the army dictator, Hossain Muhammad Ershad, to stand down. That was the only time the two ladies co-operated—and practically the last time they spoke to each other.

Late last year, more than 40 people were killed in clashes linked to the aborted election. The violence was organised by the two parties and Jamaat-e-Islami, the bigger of the BNP's two Islamist allies. As always, the fighting was the projection of rows between the two begums.

Their rivalry is based in fathomless feelings of personal grievance. Sheikh Hasina inherited the leadership of the League, Bangladesh's oldest party, from her father, Sheikh Mujibur Rahman. He was the country's independence leader, and was assassinated in a 1975 army coup along with 17 of her closest relatives. Sheikh Hasina accused Mrs Zia's husband, General Ziaur Rahman, of involvement in the coup. General Zia, as he was known, then became army chief, and declared himself president in 1977. He was himself assassinated in 1981, in which Mrs Zia says the AL had a hand. After General Zia's death, Mrs Zia inherited his party, the BNP.

Whether or not the begums believe these allegations is almost irrelevant. Their leadership claims are based on their personal loss and inherited martyrdom, of which their feuding is a constant reminder. When the AL won power in 1996, Sheikh Hasina had school textbooks rewritten to stress her father's part in the liberation struggle. When Mrs Zia returned in 2001, she changed the textbooks back.

Their grievances are multiplying. In 2004 Sheikh Hasina was fortunate to survive a grenade attack which killed 21 of her supporters. Insurgents, said to be sheltered by the army and the BNP, were to blame. In 2005 both parties were attacked in a terrorist campaign, including suicide bombings by a jihadist group called Jamaat-ul-Mujahideen Bangladesh (JMB). Its seven leaders were arrested after the explosion of 459 bomblets in 63 of the country's 64 districts, all within 40 minutes. Sheikh Hasina accused the BNP and the Jamaat-e-Islami of having sheltered the JMB. A cabinet minister pointed a finger at India, the AL's traditional ally. Six of the JMB's leaders are due to be hanged on February 17th.

The ideological basis for either party is a faded memory. The AL was once leftist and secular; the BNP, which was formed to oppose it, slightly to the right, gently Islamic, and close to the army and Pakistan. But in December the League made an election pact with radical Islamists, and in the 2001 election the previous Indian government backed the BNP. Asked whether there was any difference between the two parties, Moudud Ahmed, the former BNP law minister, said: “Yes and no, apparently not, not in policy, but there is a thin line, a difference in attitude.”

Over the past 16 years, during which the two parties ruled alternately, each of their governments misruled more extravagantly than its immediate predecessor. The BNP stands accused of massive looting, especially by businessmen close to Mrs Zia's eldest son and presumed successor, Tarique Rahman.

Because the begums do not trust each other to organise fair elections, Bangladesh's outgoing government has had to hand over to an independent caretaker government three months before a poll is due. Since this arrangement was introduced in 1996, both parties have striven to politicise the institutions, especially the judiciary, from which the caretakers are drawn. The BNP succeeded brilliantly. One electoral commissioner, appointed by the caretaker government, had sought a BNP nomination for the election.

The aborted campaign was dominated by a dispute over the composition of the caretaker government and the electoral roll. On January 3rd the League and its 16 small allies, including a party led by General Ershad, withdrew, vowing to sabotage the vote—though polling suggests that they might actually have won.

The caretaker arrangement, designed to bolster failing democracy, eased the army's intervention. Fearing a murderous election, Western diplomats issued no rebuke. Indeed the army was nudged to intervene by the United Nations, which gave warning on January 10th that it might reconsider its peacekeeping contracts with the army if it participated in a biased poll.

The threat was probably hollow. No Fijian or Pakistani blue helmet was rusticated after coups in their countries. But it remains a worry for the army. Its UN missions are a lucrative pension scheme, currently earning 11,000 soldiers around $150m a year. The army considers them proof that it has restored a reputation badly tarnished by General Ershad's dreadful rule. With that in mind, there is at least a reasonable chance that it will not overreach again.

But it will do its damnedest to force the ladies to quit. The promised arrests, especially if Mr Rahman is included, as senior officers say he will be, look designed for this. Bangladeshis have named this strategy the “Musharraf solution”, after the success of Pakistan's uniformed leader, Pervez Musharraf, in chasing his civilian rivals into exile. But Bangladesh's army is less adept at political meddling than Pakistan's. And the two ladies, together commanding 90% of the vote, are more powerful than either Benazir Bhutto or

Nawaz Sharif, Pakistan's ousted and exiled former prime ministers. Failing an unimaginable rush of public spirit on their part, or a long period of military rule, one or the other is still likely to be Bangladesh's next leader.

## Islamist shadows

Fears have been raised that the Islamists, both mainstream and a more radical margin, will profit from the hiatus. The JMB campaign gave Western countries a fright and brought a slew of unsubstantiated reports that al-Qaeda leaders were in Bangladesh. It does seem unlikely that the JMB, comprising fundamentalist peasants and rickshaw-wallahs from northern Bangladesh, acted alone. Adding to suspicions, its leader, Sheikh Abdur Rahman , once worked for the visa department of the Saudi Arabian embassy in Dhaka. But there has been no proven Islamist terrorism in Bangladesh since the JMB leaders were arrested, which suggests that Bangladeshis lack enthusiasm for such sins. Soon after it was revealed that the JMB leaders had once been linked to the Jamaat, voters in a by-election in northern Bangladesh picked a Hindu independent candidate over the Jamaat's man (both the BNP and the AL had boycotted the poll).

The way that Bangladesh practises Islam is pretty moderate: after all, its liberation struggle was, at one level, in defence of Bengal's secular traditions. As a legacy of their entanglement with Pakistan, Bangladeshi Muslims are forbidden to drink alcohol—unless they have a doctor's note prescribing it for their health. This useful document can be bought over the counter in Dhaka's bars. In one such dive, it was explained that the notes are a hangover from colonial days, when British doctors prescribed a little cognac for colds.

Nonetheless, like many Muslim countries, Bangladesh has moved towards a more bigoted Islam in recent decades, propelled partly by its politics. With around 7% of the popular vote, the Jamaat has never increased its following. But, through shifting alliances, it has increased its influence. It had its first two ministers in the last government and 18 seats in the parliament. Its violent student wing, Shibir, is relatively strong, controlling the campuses of two of Bangladesh's three biggest universities, in Chittagong and Rajshahi. However, unlike its sister group in Pakistan, both the Jamaat and the more militant groups are interested only in domestic politics. This, of course, could change.

Bangladesh faces more concrete and pressing dangers than Islamic militancy. Its 145m people live on a delta twice the size of Ireland, 40% of which is flooded for three months of each year. It is desperately overcrowded. By 2050, its population is projected to reach 250m. With almost half the country only inches above, or even below, sea-level, the prospect of climate change and rising seas is nightmarish. Around 1% of agricultural land is lost to river erosion each year.

When natural disasters arise, BNP and AL governments have both done well, with strong support from the army and NGOs. Taking measures to prevent such disasters is a different story.

One illustration is Shirajganj, a town of 200,000 people, 120km (75 miles) north-west of Dhaka, on the western bank of the 10km-wide Brahmaputra river. In recent years the river has shifted westwards at a furious rate, last year seeping across Shirajganj's embankments. On the edge of the town one local, Mohammad Nurul Islam, points to where his ancestral village lies, three kilometres into the stream. His land was submerged only last year. Until then, he was a farmer; now he is a boatman, ferrying passengers over his fields. In March, when ice-melt begins cascading down from the Himalayas, the river will rise and do worse damage. According to engineers at the town's decrepit public-works office, without urgent and massive construction of embankments, Shirajganj will be permanently submerged next year.

There is no serious effort to prevent this. And, again, the reason is the vicious political competitiveness of the begums and their parties. Since 2001, engineers have submitted more than ten proposals for embankment projects, worth 400m takas ($6m), to the finance ministry in Dhaka. They had no response. The reason, they say, is that the town's penultimate parliamentary representative, a member of the AL, was a great sponsor of embankment-building. Therefore, or so they argue, his BNP successor wanted nothing to do with it—though he did build some nice flower-beds in the town.

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Japanese justice

# Confess and be done with it

Feb 8th 2007 | TOKYO
From The Economist print edition

**Almost everyone accused of a crime in Japan signs a confession, guilty or not**

Altamira Film

A TAXI driver in Toyama prefecture is arrested for rape and attempted rape, confesses to both crimes, is convicted after a brief trial and serves his three years in prison. Meanwhile, another man, arrested on rape charges, also confesses to the two crimes the first man was convicted for. He, too, goes to jail and serves his time. Is this a story by Jorge Luis Borges, a case of trumped-up charges from the annals of Stalinist Russia, a trick question in a Cambridge tripos? None of the above. It is a recent instance, and not an uncommon one, of the Japanese judicial system at work.

On January 26th Jinen Nagase, Japan's justice minister, apologised for the wrongful arrest of the taxi driver and declared that an investigation would take place. After all, the suspect had an alibi, evidence that he could not have committed the crime and had denied vociferously having done so. But after the third day in detention without access to the outside world, he was persuaded to sign a confession.

With too many instances of wrongful arrest and conviction, few expect anything to come from the justice ministry's investigation. But the spotlight has begun to shine on the practices of police interrogation as well as on the court's presumption of guilt. More and more innocent victims of Japan's judicial zeal are going public with grim accounts of their experiences at the hands of the police and the court system.

Now a new film about wrongful arrest by one of Japan's most respected directors, Masayuki Suo, has just opened to critical acclaim. The movie, entitled “I Just Didn't Do It”, is based on a true story about a young man who was accused of molesting a schoolgirl on a crowded train—and refused adamantly to sign a confession. Thanks to support from friends and family, the real-life victim finally won a retrial after two years of protesting his innocence, and is today a free man.

The film, which was premièred in America and Britain before opening in Japan, depicts how suspects, whether guilty or innocent, are brutalised by the Japanese police, and how the judges side with the prosecutors. Mr Suo argues that suspects are presumed guilty until proven innocent, and that the odds are stacked massively against them being so proven.

The statistics would seem to bear him out. Japan is unique among democratic countries in that confessions are obtained from 95% of all people arrested, and that its courts convict 99.9% of all the suspects brought before them. Prosecutors are ashamed of being involved in an acquittal and fear that losing a case will destroy their careers. Judges get promotion for the speed with which they process their case-loads. And juries do not exist, though there is talk of introducing a watered-down system called *saiban-in* for open-and-shut cases. Apparently, members of the public are not to be trusted with cases that might involve special knowledge. Those will still be heard and ruled on—as are all cases in Japan today—by judges alone.

Despite Article 38 of the Japanese constitution, which guarantees an accused person's right to remain silent, the police and the prosecutors put maximum emphasis on obtaining a confession rather than building a case based on evidence. The official view is that confession is an essential first step in rehabilitating offenders. Japanese judges tend to hand down lighter sentences when confessions are accompanied by demonstrations of remorse. Even more important, prosecutors have the right to ask for lenient sentences when the accused has been especially co-operative.

It is how the police obtain these confessions that troubles human-rights activists. A suspect can be held for 48 hours without legal counsel or contact with the outside world. After that, he or she is turned over to the public prosecutor for another 24 hours of grilling. A judge can then grant a further ten days of detention, which can be renewed for another ten days.

Japan's constitution also states that confessions obtained under compulsion, torture or threat, or after prolonged periods of detention, cannot be admitted as evidence. Yet threats and even torture are reckoned to be used widely in detention centres—especially as interrogators are not required to record their interviews. Accidental death during custody happens suspiciously often. Facing up to a possible 23 days of continuous browbeating, or worse, could persuade many wrongfully arrested people to accept their fate and sign a confession as the quickest way to put the whole sorry mess behind them.

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South-East Asia

# Let's all bash Singapore

Feb 8th 2007 | BANGKOK
From The Economist print edition

**The rich little place that the others love to hate**

AFP

**Not envious at all**

SINGAPORE won South-East Asia's football championship on February 4th in a final against Thailand that was mostly peaceful, despite a bad-tempered first leg in which the Thais stomped off the pitch and sulked for 15 minutes. The players were doing no more than imitate their military-run government, which has been in a strop with Singapore since Singapore's deputy prime minister met Thaksin Shinawatra, the deposed Thai leader, last month. In protest, top-level meetings with Singaporean officials were cancelled. General Sonthi Boonyaratglin, the Thai junta's leader, accused Singapore of spying on Thailand, using the telecoms business it bought last year from Mr Thaksin's family. He told his soldiers to stop using their mobiles and go back to walkie-talkies.

Despite 40 years of expressing fraternal warmth at meetings of the Association of South-East Asian Nations, the region's leaders never miss an opportunity to pick a fight with Singapore. In recent years, Singaporean firms, many of them state-backed, have bought businesses across the region, providing cause for paranoia. Indonesian parliamentarians claimed this month that their military secrets were also at risk because the Singaporeans had bought into a local satellite firm.

Even sand is a matter of national security. On February 6th, an Indonesian ban on sand exports came into force, following a similar move by Malaysia some years ago. Singapore buys the sand to reclaim land from the sea and increase its puny terrain. Indonesia's official reason for the ban was to stop the environmental damage caused by sand mining. But a senior navy man let slip that it was motivated by various diplomatic spats with Singapore. The Indonesian navy has now sent no fewer than eight warships to its maritime border with Singapore to intercept suspected sand-smugglers. At the same time, the Indonesian sand-shovellers' association, facing unemployment, is threatening to sue the government over the ban.

The Malaysians, always up for a row with their estranged ex-spouse (Singapore and Malaysia were in a brief, unhappy union in the 1960s), are blaming their recent floods on Singapore's land reclamation. Mahathir Mohamad, Malaysia's disgruntled former prime minister, has sought to undermine his successor, Abdullah Badawi, by accusing him of secretly negotiating with the Singaporeans to lift the sand ban. Mr Mahathir also added his voice to the Thai junta's attacks on the Singaporeans: “You'll get nowhere with them either being nice or being tough, they only think of themselves,” he said on Thai television.

There is always a plausible-sounding reason for the fights that Singapore's neighbours pick with it. The Singaporeans' *kiasu* (win at all costs) negotiating style does them few favours in a region where saving face is important. But it is hard to avoid the suspicion that the little country's unforgivable offence is being richer and more successful than its neighbours, and not particularly apologetic about it.

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Australia's culture wars

# To flag or not to flag

Feb 8th 2007 | TAYLORS ARM
From The Economist print edition

**How Australians see themselves has become a theme for the coming election**

Get article background

THE small town of Taylors Arm, in the rolling farmlands of northern New South Wales, was once famous as the setting for “A Pub With No Beer”, an Australian country song. The customers who flocked to the pub for Australia Day on January 26th were displaying a fashion that has not been much in evidence in the 50 years since the song was a hit: many were carrying an Australian flag, or had one stamped on their bodies. Until recently, the flag was rarely flaunted. Now, few politicians risk a television statement without being seen to be standing next to it.

As Australia's federal parliament came back this week from its lengthy summer break, the flag's rebirth has become a symbol of the so-called “culture wars” that are likely to reverberate through the general election later this year. John Howard, the prime minister, who will be seeking a fifth term for his conservative coalition government, has successfully stoked these wars to win four elections since 1996.

But this time he is facing Kevin Rudd, who took over as leader of the opposition Labor Party in December and who has staked out a tough response to Mr Howard's cultural definition of Australia. An opinion poll on February 6th gave Labor a 12-point lead over the government, after the distribution of second-preference votes, compared with the two points it had just before Mr Rudd's ascension. Voters also rated Mr Rudd 16 points ahead of Mr Howard in their approval rating (compared with an 18-point deficit for Kim Beazley, Mr Rudd's predecessor). Despite these good showings, however, Mr Rudd faces a big battle to persuade voters to buy his picture of themselves.

The culture war stems from a bid, by the Labor government defeated in 1996, to redraw Australia's national identity. Labor's picture of the country focused on multiculturalism, closer ties with Asia, breaking the constitutional link with the British monarchy and making amends for past wrongs to indigenous people. Mr Howard robustly rejected all that.

On Australia Day last year (the holiday marks the British settlement of Australia in 1788), he launched a campaign to revive the teaching of Australian history in schools and to recapture the “values, traditions and accomplishments of the old Australia”. This was code for the old British, pre-multicultural Australia. In a speech last October the prime minister lauded certain historians who had rebuffed “the black armband view of Australian history”. To Mr Howard, this mournful version paints the country's story as “a litany of sexism, racism and class warfare” and is a product of the “posses of political correctness”.

Mr Rudd countered in November with “Howard's Brutopia”, an article in the *Monthly*, a centre-left journal. He called the prime minister's culture war a strategy drawn from the American Republican Party, designed to raise fears and then offer voters what appear to be old certainties: “tradition versus modernity, absolutism versus moral relativism, monoculture versus multiculture”. All this, pronounces Mr Rudd, is a cover for “the values debate...that Howard is desperate not to have”. He defines the debate he wants as a battle between treating people fairly and the “market fundamentalism” of Mr Howard's economic policies.

The unfurling of flags in Taylors Arm and elsewhere suggests that Mr Howard's brand of inward-looking Anglo nationalism may still be doing rather well. But, come the election, Mr Rudd has other things on his side: relative youth (at 49 he is 18 years Mr Howard's junior), stability and drive. He has made the running with climate change and education, two issues that register strongly with voters.

On the other hand, Mr Howard has the advantage of incumbency, a successful record as a ruthless political strategist and an economy that is humming into its 16th year of uninterrupted growth. The opinion poll identified a large corps of swing-voters. No doubt it will be they who decide which way the

election goes, and perhaps the culture war too.

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**Chinese babies**

# The golden pig cohort

Feb 8th 2007 | BEIJING
From The Economist print edition

**As China enters an auspicious year, the birth rate is expected to soar**

EPA

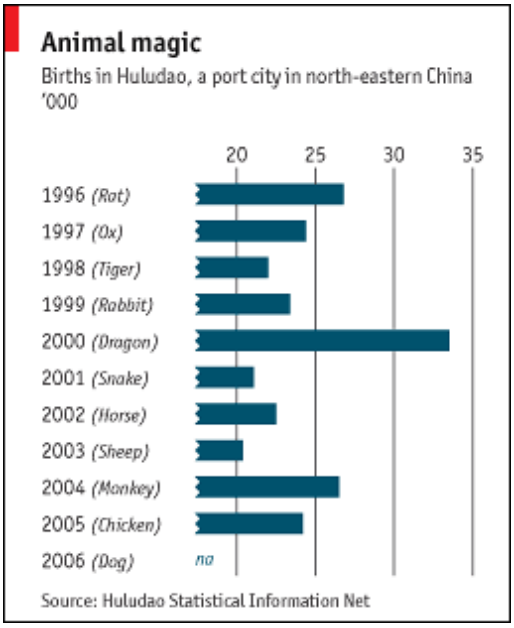
HOSPITALS across China are bracing themselves for what is expected to be a surge of babies born in the year of the pig, which starts on February 18th. Pig years, which occur every 12 years, are considered auspicious. But the coming one, or so many believe, will be especially fortunate since it is not just a pig but a golden pig, the first in 60 or even 600 years, depending on which astrologer one consults.

China's state-owned media have carried numerous stories of gynaecologists struggling to cope with unusual numbers of expectant women. *Life Times*, a weekly newspaper, quoted an official as saying that Beijing alone could see 170,000 births this year, 50,000 more than in 2006 (quite an auspicious year itself). The increase is partly the result of a mini-baby boom in the 1980s, which was in turn caused by a boom two decades earlier. But officials say the golden pig has much to answer for.

In recent years, Hong Kong has become a magnet for urban Chinese women trying to evade China's strict one-child policy and enjoy better standards of hospital care (often free since many leave without paying their bills). But those hoping for a golden pig baby in Hong Kong will face difficulties. To stem the influx, Hong Kong introduced new rules on February 1st requiring mainland women who are more than seven months pregnant to prove they have a hospital booking in the territory before they can cross the border.

China's top family-planning official, Zhang Weiqing, said last month that given the current bulge in the number of people reaching childbearing age, the government would not relax its one-child policy. This will probably mean that the golden pig's impact on the birth rate will be followed by a correction once the auspicious period is over (next year is also being tipped as lucky, what with the Olympics and all).

But problems are bound to arise as the golden pig cohort reaches school age. In some parts of China, children born in 2000, the year of the dragon (also very auspicious, as suggested by the chart), are already facing stiffer than usual competition for places. In Shanghai last week, deputies to the local legislature's advisory body called on city planners to start taking account of auspicious years when considering education demand. They also appealed to citizens to abandon superstition, but that is much less likely to be heeded.

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Russia and the Middle East

# The bear is happy to be back

Feb 8th 2007 | CAIRO
From The Economist print edition

David Simonds

**Clever diplomacy has brought Russia back into the regional power game**

AS RUSSIA'S president heads to the Middle East this week, the former KGB lieutenant-colonel may relish the fact that, here at least, his country is recouping some of its cold-war losses. Vladimir Putin's Russia is still less of a player than it was. It no longer has a network of Soviet client states. It does not baldly challenge Western interests by backing revolutionary forces and flexing its own military might. But Mr Putin has exploited the decline in American prestige, brought about by, among other things, the Iraqi morass and the poisonous issue of Israel and Palestine. So he may find it easier to reinsert Russia as a counterweight to the lone superpower.

In some ways, last summer's fight between Israel and the Lebanese guerrilla group Hizbullah echoed the cold war: a clash between proxy forces that tested armaments and tactics. While Israel's American-supplied gadgetry was far more lethal, Hizbullah's Russian weapons were effective too. Its anti-tank missiles knocked out scores of Israel's armoured vehicles.

Russia is not a direct sponsor of Hizbullah. The Shia militia smuggled its arms via Syria and Iran, states that are now Russia's customers rather than strategic allies. Confronted with evidence of unauthorised "leakage" of arms to Hizbullah, Russia is said to have quietly apologised to Israel and promised to tighten controls. Given that Israel is home to 1m Russian-speakers, the Kremlin is keen to keep on friendly terms with the Jewish state.

Yet it is also content to reap gains from the impression that it opposes America's overweening power. After Russia secured a $7.5 billion deal to supply Algeria with fighter aircraft, tanks and anti-aircraft missiles, its army chief of staff, Yuri Baluyevsky, recently echoed Mr Putin, saying that the American effort to create "a unipolar world" was fomenting crisis. Russia's foreign minister, Sergei Lavrov, told an Arab newspaper earlier this month that Russia has returned to the world as a strong and confident power. This, he said pointedly, is "an important factor on the path to restoring balance in world affairs and on moving towards ensuring stability and predictability rather than chaos."

At this week's meeting of the Quartet, a club of Russia, America, the EU and the UN which is meant to push Palestinians and Israelis towards peace, Mr Lavrov publicly sparred with Condoleezza Rice, America's secretary of state. Referring to America's policy of shunning Hamas, the Islamist party that won last year's Palestinian elections, he said it was counterproductive to isolate anybody. He later

blamed America for dimming peace prospects by applying a “with us or against us” standard to interlocutors and called Russia's relations with America troubled.

Russia does not have great influence over Arab-Israeli matters. As American officials happily point out, it contributes barely 1% of foreign aid to the Palestinian Authority. When Mr Putin last year proposed hosting a Middle East peace conference in Moscow, Israel ignored him. Yet Russian diplomacy has used its clout to great advantage elsewhere in the region.

Take Iran's nuclear ambitions, for instance. By posing as the sole major power to take seriously (at least in public) Iran's protestations that its nuclear programme is innocent, Russia has gained both commercially and diplomatically. Aside from its $800m contract to build a nuclear reactor at Bushehr, Russia has won a commitment to supply six more plants. This props up Russia's own creaking nuclear industry, improves its chances of selling the technology elsewhere, and keeps Iran from criticising Russian policy in Muslim Chechnya.

Yet the commitment, underlined last year by the sale to Iran of anti-aircraft systems that could help defend nuclear installations from cruise missiles, among other threats, has also boosted Russia's role as an arbiter. As Iran has prevaricated in its dealings with the UN Security Council and the International Atomic Energy Agency, Russian engineers are understood to have slowed completion of the plant at Bushehr, now not expected to come on stream until the autumn. Russia has also declined Iran's requests for fancier anti-aircraft missiles, saying its order books are full.

This does not soothe American and Israeli critics, who suspect that Russia has made a devil's bargain with the Islamic Republic. But it does mean that when Russia voted, in December, in favour of a UN Security Council resolution to sanction Iran for proceeding with plans that might let it make nuclear weapons, Iran's leaders sat up abruptly and listened harder. Russia would like to think that the recent slight softening of Iran's public tone and the rising domestic criticism of its president, Mahmoud Ahmadinejad, may owe something to fears of losing its only legitimate outside source of nuclear technology.

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The Gulf states

# Buying up art and culture

Feb 8th 2007 | CAIRO
From The Economist print edition

**A spending spree to get culture and learning**

COSMOPOLITAN atmosphere, Arabian charm: how life should be. So declare brochures for Saadiyat Island, a colossal and luxurious waterfront community soon to rise on the outskirts of Abu Dhabi, capital of the United Arab Emirates (UAE). But to lure Saadiyat's would-be 45,000 home-owners away from the glitz of Dubai, next door, Abu Dhabi knows it must offer a bit more.

Dubai already has giant shopping malls, beach hotels and skyscrapers. What it lacks is culture. Not the vibrant commercial culture of a booming, polyglot entrepôt, but the big-name, big-draw culture of hallowed institutions and famous works of art. So Abu Dhabi has stolen a march on its rival by buying a good chunk of such stuff—off the shelf.

Last year it signed a deal for New York's Guggenheim Foundation to create a world-class modern-art museum as a showpiece for Saadiyat Island's Culture District. The $400m building, to be designed by a Los Angeles architect, Frank Gehry, is billed as the biggest yet in a spreading franchise of Guggenheims in such outlets as Berlin, Bilbao and Venice.

Abu Dhabi is negotiating to build a Louvre too: not a replica of the Paris palace but a huge translucent dome filled with fountains to be designed by a Frenchman, Jean Nouvel. Under a contract said to be worth up to $1 billion, a consortium of top French state museums would lend works, advise on an ambitious acquisitions plan, and lease the Louvre brand name for an eventual museum of classical and ancient art.

Other projects for the Culture District include a performing arts centre designed by Zaha Hadid, a Baghdad-born British woman, and a maritime museum by Japan's Tadao Ando. Abu Dhabi is also pitching to a different kind of audience with Ferrari World, a red-hued theme park celebrating the famed racing cars. And it has opened a fully-fledged branch of the Sorbonne, the Paris university.

That has boosted the emirate's position in what has become a race among wealthy Gulf states to woo prestigious seats of learning. So far Qatar is in the lead, with branches of five top American colleges, as well as the Rand Corporation, a California think-tank. Its latest acquisition is a branch of St Cyr, the French military academy. Sharjah, another of the seven statelets making up the UAE, plans to host an outpost of INSEAD, a Paris business school.

Its graduates are needed. In the past four years, the six countries in the Gulf Co-operation Council have seen their annual income from oil exports soar from $100 billion to $325 billion.

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Somalia

# It isn't nearly over

Feb 8th 2007 | NAIROBI
From The Economist print edition

**Waiting for peace, peacekeepers and the germ of an economy**

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AP

**In a mood for compromise?**

A FULL month after the routing of Islamist forces in Somalia, it is hard to say whether the country is slipping back into anarchy or limping forward towards reformed statehood: like a tennis stroke, it all depends on the follow-through. The signs are not promising.

Having shredded Islamist fighters with air strikes, and then admitted it missed its intended targets, America is offering only token sums to put Somalia back on its feet. A generous American package would be received with suspicion by Somalis, but the European Union (EU) is being just as stingy. True, the Somali transitional government has almost no capacity to absorb money, and foreign aid-workers remain a target of rogue gunmen. But the lack of a follow-through extends most patently to the promised African Union (AU) peacekeeping force. So far, no peacekeepers of any kind have arrived, unless you include the Ethiopian force that toppled the Islamists and is meant to be going home soon.

African governments have so far promised only 4,000 of the 8,000 soldiers needed to hold the line in Mogadishu, Somalia's capital. Ugandans, Nigerians and Ghanaians will arrive within a month, letting Ethiopia withdraw. It is uncertain who will pay for the operation or what will happen if things again turn nasty in Mogadishu. Life there is already getting jittery, with daylight attacks on Ethiopian troops and night-time mortar and rocket assaults on the presidential palace, hotels and port, probably by remnant Islamist fighters.

The hunt for three al-Qaeda men believed to be hiding in Somalia continues. Ethiopia says it is working on America's behalf to test the DNA of corpses littering groves in south Somalia. None has so far provided a match for the al-Qaeda men. Tattered and bloodied papers belonging to Aden Hashi Ayro, a commander of the jihadist militia connected to the Islamic courts, have been recovered, but it is not clear if Mr Ayro bled to death or escaped.

Either way, the sense of inviolability the jihadists once exuded is gone. Ethiopians paraded a captured Islamist cleric in the port of Kismayo: they had found him riddled with bullet holes among dead Islamist fighters and patched him up to become an unlikely apologist for the transitional government. A moderate leader of the Islamic courts, Sheikh Sharif Ahmed, has since been given asylum in Yemen, possibly with the backing of America, which thinks he could be useful too.

Then there are the foreign fighters. There were probably few of them, their fate pathetic. Some died on the battlefield, more were shot up in the mangrove swamps along the Kenyan border. Stragglers were picked up by Kenyan security forces and sent to police cells in Nairobi. A Kenyan human-rights group says that two of those caught were American.

The big question is whether the Somali government has the stomach for genuine national reconciliation. At a top-level meeting this week in Mogadishu there were appeals for unity. The rhetoric sounded promising, but some ministers will have to renounce their posts and clan influence in favour of some of those who backed the Islamic courts. Three ministers were sacked and the cabinet shuffled.

Reconciliation runs two ways: the government is asking Somalis to look generously on neighbouring

Ethiopia, whose forces have acted mostly with restraint but who are widely despised. And even if AU troops do keep the peace, Somalis must fast find a way to revive their shattered economy. Their country needs help to overhaul its informal banking system, to market and export its fruit and livestock, and to protect its vast fishing grounds from illegal tuna-catching boats, some of them from the EU. In particular, thousands of young gunmen, most of them uneducated and without prospects, need jobs.

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South Africa

# Looking in the mirror

Feb 8th 2007 | JOHANNESBURG
From The Economist print edition

**Why is a review of South Africa by its African peers being delayed?**

Get article background

AMID fanfare and hope, a “New Partnership for Africa's Development”, known as Nepad, was proclaimed five years ago as a “vision and strategic framework for Africa's renewal” under the auspices of what was soon to become the new-look African Union (AU). Two years later, one of its most novel and ambitious ideas took shape. In order to keep each other up to a new democratic mark, the bravest and most candid of Africa's governments would allow themselves to be judged by their peers. Hence the creation of an African Peer Review Mechanism, whereby panels of independent-minded men and women from across the continent would assess each country as it dared to step forward to be scrutinised.

Rwanda and Ghana boldly put themselves forward, followed by Kenya. Mauritius is also under review. Next up was South Africa, the continent's undisputed economic and democratic heavyweight. Its willingness to be judged, warts and all, was seen as big fillip for this voluntary mechanism, which is intended to prod governments into performing better, since the public assessments of them could be embarrassing. Some think the South African government is peeved by the draft review now in unofficial circulation, though it insists it has had nothing to do with a decision to delay publication until the next AU meeting, in July. Officially, Africa's leaders said that the report was simply not yet final.

At last month's AU summit in Ethiopia's capital, Addis Ababa, a discussion of the peer review of South Africa among the leaders of the 26 countries which have signed up to the idea had been heralded. The review panel had submitted its draft report in November, and the South African government was supposed to respond forthwith. But a revised “action plan” was presented by South Africa just before the summit. There was apparently too little time to incorporate it and finalise the panel's report.

Though the draft report highlighted South Africa's post-apartheid achievements, including its liberal constitution, sound economic policy, generally sensible new laws and free politics, it did not shy away from spelling out problems it has yet to solve: still brittle race relations, rising xenophobia (against immigrants from Zimbabwe, for instance) and the lingering reluctance of some whites to embrace the new South Africa. The reviewers also worried that “black economic empowerment”, which is meant to redress the injustices of apartheid, has benefited mainly a lucky few, and that politicians have moved into business with unseemly haste. The reviewers were also worried about the HIV/AIDS epidemic, the persistence of many inequalities and South Africa's exceptionally high level of violent crime. Moreover, the report said, ordinary people feel disconnected from those they have elected.

Before the panel's country report, South Africa had made its own self-assessment. The government says it was based on an unprecedented array of public consultations and followed the rules. But independent groups complain that it consistently sacrificed quality for speed. According to Ross Herbert of the South African Institute of International Affairs, who was closely involved, the government was heavy-handed in managing the process, removed or downplayed problems (including corruption, crime and weaknesses in the country's democratic system) after the text was publicly endorsed, and bent the rules by putting a minister in charge of the council that oversaw the self-assessment. Even more disappointing was the action plan, perhaps the essence of the exercise. Mr Herbert says it ended up being vague and incomplete, and was revised without consultation just before the AU summit.

So will the peer-review mechanism survive in its intended, rigorous form? After more than three years, only three countries have gone all the way through the mill; South Africa seems loth to do so without constraints. If things are to improve, the scope—it is being said—may have to be altered, the methodology clarified and the Johannesburg-based secretariat beefed up. Ultimately, the mechanism's

success will depend on the countries that sign up to it. In South Africa, it has at least sparked a public debate.

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Congo

# Keep the United Nations engaged

Feb 8th 2007
From The Economist print edition

**International peacekeepers are still sorely needed**

THE UN's peacemaking effort in Congo is still being praised in song by one of the country's liveliest comedians, Mira Mikanza. “When Koko [Grandpa] Souing [Swing] comes into the game/No one will shoot,” sings Mr Mikanza in tribute to the UN's William Swing, who for nearly four years has headed the UN's mission to Congo, better known by its French acronym, MONUC.

The song of praise is deserved. In October MONUC oversaw the more or less orderly run-off of a presidential election, won by the incumbent, Joseph Kabila. But the peace is shaky. The UN's 17,000 peacekeepers are struggling to keep Congo calm.

But MONUC's continuing existence in such necessarily large numbers is far from guaranteed. It costs about $3m a day, at a time when the UN's overall budget is under severe strain. The UN's new secretary-general, Ban Ki-moon, visited Congo last month and told the country's 60m-odd people that they could “count on us”.

The peacekeepers are expected to stay for the time being. But it is less sure that the UN's teams trying to foster civil institutions and encourage Congo's politicians to respect the new constitution will be kept on. “We're in enormous competition with the other missions,” says Mr Swing, an American. “It's a hard sell.” MONUC's mandate is up for renewal this month.

Plainly, MONUC is still needed. Armed groups operate largely unchecked, especially in Congo's unruly east. Last week Mr Kabila's police and soldiers cracked down on opposition protests against the results of recent provincial governors' elections, killing at least a hundred people.

This has put MONUC in a quandary. It is supposed to protect Congo's civilian population, while helping to build up and train the revamped security forces. But the new army is widely viewed as Congo's main human-rights abuser. MONUC refused to condemn the recent killings outright. Moreover, Mr Kabila is keen to assert a new sense of sovereignty. He tellingly refused to greet Mr Ban on his arrival in Kinshasa, the capital, but met him instead in the provincial city of Kisangani, in Congo's east, where the president is more popular.

The UN Security Council is due to vote to extend MONUC's mandate next week. There is a worrying sense of drift. It would be tragic if, after the huge effort the UN has put into mending Congo, it slides back into misgovernment and violence.

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The Caucasus

# Hanging together

Feb 8th 2007 | BAKU
From The Economist print edition

AFP

**The implications of a diplomatic shift in an important oil-rich region**

Get article background

WHEN God was parcelling out land to the peoples of the earth, the Georgians arrived late. But their explanation—that they had been drinking in his honour—so delighted God that, according to a Georgian creation myth, he granted them the world's choicest spot. The gods have indeed favoured Georgia this winter, bestowing a mild one when a harsh one might have been disastrous. But the Georgians owe thanks also to an earthly benefactor: their neighbour Azerbaijan, whose oil-fuelled foreign policy is transforming the volatile but vital Caucasus.

Since the revolution of 2003 that swept Mikhail Saakashvili to Georgia's presidency, his yen to join NATO and the European Union has infuriated the Kremlin. Last autumn, the Russians imposed postal and aviation blockades, alongside the existing embargoes on Georgia's water, wine and fruit. Then, with winter approaching, they doubled the price for Russian gas—in theory for commercial reasons, but with the real aim of taming Mr Saakashvili.

Yet, for all Mr Saakashvili's high-profile rambunctiousness, the most important country in the Caucasus is Azerbaijan. With around 8m people, most of them Shia Muslims, it has the biggest population. It also has oil and gas, which a consortium led by BP is extracting from the Caspian Sea and pumping through new pipelines across Georgia to Turkey and beyond. All the Caucasian economies are now picking up, after collapsing with the Soviet Union—even corrupt Armenia's, dependent though it mostly is on remittances. But the growth created by Azerbaijan's second oil boom (the first was 100 years ago) was the highest in the world last year: 34.5%, says the finance minister.

Azerbaijan's president is Ilham Aliev, who inherited the job from Heidar, his strongman father. The younger Aliev seemed also to have inherited the Caucasian skill of diplomatic balance, eschewing Georgian-style pyrotechnics. But that careful equilibrium appeared to change in December, when the Russians tried to hike the price of the gas that, despite its own reserves, Azerbaijan was itself still importing. The idea was apparently to stop Azerbaijan helping the Georgians with cheaper supplies.

“Commercial blackmail,” said Mr Aliev. Azerbaijan stopped importing Russian gas altogether—and, thanks to the warm weather, gas from Azerbaijan seems set to help Georgia through the winter. Elmar Mammadyarov, Azerbaijan's foreign minister, says his country is merely “taking responsibility as a regional leader.” Mr Saakashvili is more exuberant: “a geopolitical coup”, he says of the new gas

arrangements. The truth is, Mr Aliev now needs Mr Saakashvili too. Azerbaijan's future, and Mr Aliev's power, rest on the new pipelines, which have bound their two countries together, and bound both of them to the West. In a few years they may also carry Kazakh oil from the other side of Caspian, and—perhaps—gas from Turkmenistan. That would undo Russia's grip on the supply of Central Asian gas to Europe, and is as unpopular an idea in Moscow as it is welcome elsewhere.

Two things undermine the hope that the fractious Caucasians have finally learned to hang together, to their own benefit and that of Western energy consumers.

One is domestic politics. Russia's diplomatic power may be waning, but its political model remains popular. Armen Darbinian, a former Armenian prime minister, quips that his and other post-Soviet countries have become “one-and-a-half party states”: a party of power, plus others that are basically decorative. In Azerbaijan, opposition activists are regularly harassed and locked up. Like Russia, Georgia, Armenia and Azerbaijan will all hold presidential polls next year. Mr Aliev will surely win his; the whisper in Baku is that his wife will take over next. But another whisper is that, in the absence of democracy, Islamism is on the rise—encouraged, say some, by Iran to the south.

The Islamists, says Ali Kerimli, a disgruntled oppositionist, curry favour with their complaint that “the West sells democracy for oil.” Others say the threat is fanciful. The call to prayer rings across the boutiques and restaurants of downtown Baku, but there are actually more hijabs on the streets of London, says Ilgar Ibrahimoglu, an imam. All the same, things may change if too much of the oil money goes into nepotistic contracts and vanity projects, and too little on diversifying the economy and easing the grinding poverty in which many Azerbaijanis still live.

The other big Caucasian danger is war. Russian support for South Ossetia and Abkhazia, two enclaves that broke away from Georgia in the 1990s (see map), is one of Mr Saakashvili's main gripes. Azerbaijan also lost a secessionist conflict over Nagorno Karabakh, a part of Soviet Azerbaijan mostly populated by Armenians. Mr Aliev periodically makes dark threats about retaking Azerbaijan's lost territory by force, though a flare-up in Georgia currently looks likelier.

Mr Saakashvili says Russia's economic embargo “achieved the opposite of what was intended”, and that Georgia has found new markets. Suitably cheered, he this week hosted Mr Aliev and Turkey's Recep Tayyip Erdogan, shaking hands on a new railway that will link the Caucasus to Europe—but miss out Armenia. Vartan Oskanian, Armenia's foreign minister, complains that there is an existing railway across Armenian-controlled territory that could be used instead. The railway, like the pipelines, symbolises what the countries of the Caucasus can achieve together, but also how far apart they remain.

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Germany's nuclear power

# A policy of denial

Feb 8th 2007 | BERLIN
From The Economist print edition

**The nuclear lobby warms to a changing future in the energy world**

Get article background

STEPHAN KOHLER climbs mountains and used to assess the safety of nuclear power plants. Now he is chief executive of DENA, a government agency to promote energy efficiency. Nothing can persuade him that nuclear power is an acceptable risk—unlike mountain-climbing, which, he says, puts only his life in danger.

Mr Kohler is not alone. Millions of Germans want to end their exposure to atomic power, hence the agreement back in June 2000 by the main political parties and the nuclear industry to shorten the life of the country's 17 plants and shut them all down by around 2020. In November 2005 that timetable was confirmed by the new government's coalition agreement.

AFP

**Thought embargo?**

But the world has changed. Amid the political games being played by Russia and its neighbours, Germany's oil and gas supplies appear less secure. And as the current president of the European Union and the G8, Germany is trying to provide leadership in the new war against $CO_2$ emissions. It wants to reduce greenhouse-gas emissions to 40% below 1990 levels by 2020. Key to the energy plan, besides more wind farms and solar panels, and less leaky buildings, is the development of clean coal-fired power plants. But the technology is in its infancy. Two pilot plants will not be ready before 2014.

One answer: stretch the average life of nuclear plants, which are emission-free, from the agreed 32 years to a scientifically acceptable 40 (in America their life is already being stretched to 60 years). Then there would be time to develop better clean and renewable technology. “The disadvantages are hard to see,” says Manuel Frondel at RWI, a research group. “Even if we shut down all our atom plants we would probably import nuclear power from France or central Europe: that would be pushing the problem to the west and east. We still haven't found more than interim solutions for storing nuclear waste, but that quest is not insoluble, and it is not exacerbated by continuing to run plants.”

A timely piece of research by Deutsche Bank boldly states that phasing out nuclear power plants “is not a viable policy option.” Instead it recommends stretching their life to 60 years and taxing the windfall profits to subsidise clean coal plants, which could not otherwise compete with gas-fired alternatives. So confident is Deutsche Bank that this government, or the next, will have to revise its nuclear policy, that it assumes the change in its forecasts for the share prices of RWE and E.ON, Germany's two biggest nuclear operators.

The power companies have started manoeuvring. In December, RWE and EnBW, another German nuclear operator, each made applications, under the terms of the 2000 agreement, to shift capacity from a younger nuclear plant to one that is older. Both argue that this will allow them to operate and phase out two side-by-side plants—one old, one newer—in harmony, and it will buy them time to develop alternative technologies. “This is not just cosmetic pre-election tactics,” says Utz Claassen, chief executive of EnBW.

But Mr Claassen—not known for his political naivety—is aware that 2009 will bring new federal elections and the end of the coalition agreement. Unless the lives of his and RWE's oldest plants are reprieved by a

capacity shift, then that is about the time they will have to be shut down. A Deutsche Bank-style extension to 60 years would allow the veteran plants to purr on beyond 2030.

The nuclear lobby is being very careful, but “there should be no *Denkverbot* [thought embargo]”, says Bernd Arts of the Atomforum in Berlin. Chancellor Angela Merkel herself is displaying symptoms of schizophrenia on the subject: “I stick to the coalition agreement,” she told the Sunday *Bild* newspaper on February 4th. “But whoever wants to get out of nuclear energy must find some serious answers to meeting environmental targets. Renewable energy cannot be a complete answer by 2020.”

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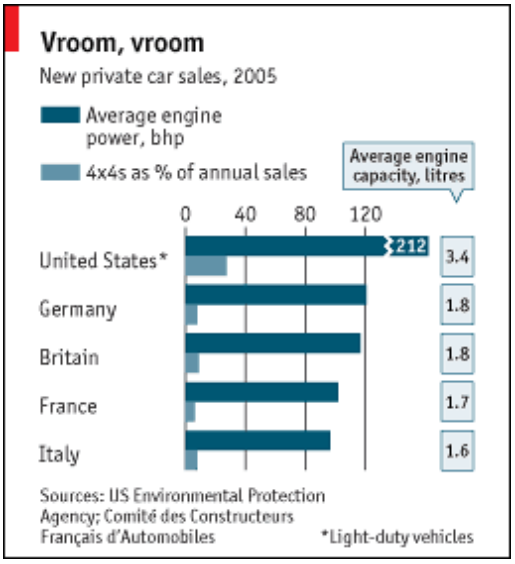
**Europe's car emissions**

# Setting the target

Feb 8th 2007
From The Economist print edition

### National lobbies are trying to outrun the Commission




YOU know a row has turned venomous in the European Union when the squabblers resort to national name-calling. The current fight pits Europe's carmakers, notably from Germany, against the European Commission, which wants to impose sharp reductions on the amount of carbon dioxide that new cars sold in Europe from 2012 may pump out. The lobbying has been ferocious. When it comes to cars, national passions run deep.

Calling for tweaks to the plan in favour of gas-guzzling cars, the German chancellor, Angela Merkel, said her country would “fight with all its strength” to get its way. The boss of Porsche talked last month of a “business war” against countries that make mostly smaller cars, such as France and Italy. Volkswagen told the Commission the cuts were unworkable.

And so at the last minute, the proposals, announced on February 7th, were watered down: they would now trim the $CO_2$ emissions of the average new car sold in Europe to 130 grams per km driven, a cut of about a fifth from present levels. A further 10g of $CO_2$/km would be saved with more efficient tyres, air-conditioning and so on.

On the face of it, the ferocious lobbying is rather odd. Germany pledged that the fight against global warming would lie at the heart of its current six-month shift as president of the European Union.

The whiff of hypocrisy has not escaped the EU environment commissioner, Stavros Dimas, who this month demanded that Germany should live up to its “nice speeches”. In case anyone missed the point, he let it be known that he was ditching his official Mercedes in favour of a hybrid car from Japan.

That hurts. Europeans are deeply nationalistic about the cars they drive. Nine out of the top ten cars sold in France in 2005 were French. German brands achieved the same score in their own home market. In Italy, Fiat and Lancia grabbed three out of the top five spots. Swedes love their Volvos and Saabs.

Horsepower also varies widely from country to country, and that matters. For all the improvements in engine technology, there remains a link between oomph under the bonnet, fuel consumed and the amount of $CO_2$ you leave trailing behind you. Germans, Swedes and British drivers favour relatively powerful engines, while the French and Italians make do with markedly less horsepower.

Size matters, too. French and Italian drivers may love speed, but they zoom about in relatively small cars. Practicality plays a part, and psychology. If you live in an ancient, congested city, a tiny car is all you need. You can also park it near your *inamorata*'s flat, which is cool.

There is no inherent difficulty in making cars that emit 130g$CO_2$/km. It is just hard to meet the target if you want a big car, or one with blistering acceleration. Italy's top two sellers, the Fiat Punto and Panda, already match or beat the proposed target. Several Peugeot, Citroën and Renault diesels do even better. But these are small cars, or mid-sized runabouts with sluggish acceleration. None of which is much help to firms with luxury and performance at the centre of their brands. The average new Porsche emits 297g$CO_2$/km.

The commission proposal must now be considered by national governments and the European Parliament. More fights loom. Makers of beefy cars, worried that they cannot hit $CO_2$ targets as individual companies, want average emissions calculated across the entire European market. Mrs Merkel wants different targets for different weight-classes of car.

The carmakers say that they are being made to carry too much of the burden for cutting emissions. Cutting traffic congestion, they argue, can be more cost-effective. They may win some of the coming fights in Brussels. But the European Commission is not alone in looking at $CO_2$ emissions. National governments and local authorities across Europe are looking to link $CO_2$ emissions to taxes, congestion charges and even parking fees. Change is coming, and big engines will not outrun it.

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**Albania's energy problem**

# Switching on the lights

Feb 8th 2007 | ATHENS
From The Economist print edition

### Not enough help from the neighbours

Get article background

WINTER in Albania, Europe's second-poorest country (after Moldova), is a wretched season, bringing power-cuts of 12 hours a day in the cities and 20 hours in the countryside. Hence the brisk import each autumn of portable oil-fired generators: without their own private electricity supply, the thousands of small businesses that drive the economy would collapse.

This year the electricity shortage is worse than usual. A drought has severely reduced water levels in dams that feed the elderly hydro-power plants along the Drin river in the north of the country. Thirty years ago these were the pride of the late Enver Hoxha's Stalinist regime: Albania even exported electricity to Greece and Yugoslavia.

Now the situation is reversed: electricity demand is growing at almost three times the European average as more Albanians move to the cities and furnish their homes with dishwashers, tumble-dryers and electric heaters—paid for by remittances from relatives working abroad. KESh, the inefficient and corrupt state electricity utility, struggles to send bills to, and collect money from, people living without addresses or electricity meters in squatter suburbs around Tirana.

Albania used to get by with free or heavily subsidised electricity imports from Italy, its friendliest neighbour, and with cheap supplies from Bulgaria, the region's biggest exporter. But last month two Chernobyl-era units were shut down at Kozloduy, Bulgaria's nuclear-power complex on the Danube, as a condition of Bulgaria's accession to the European Union. That has led to Bulgaria cutting electricity exports by more than two-thirds—and so to soaring energy prices in the Balkans. Meanwhile, Albania's electricity shortage is showing up in slower economic growth and less foreign investment than elsewhere in the western Balkans.

In an attempt to find a solution, the World Bank, Italian energy companies and private consultancies have come up with a stream of proposals to modernise hydro-power plants, reduce transmission losses and build new power stations close to fast-growing towns in the centre and south of the country. But only one large project has made progress. After several years of foot-dragging by the energy ministry, an Italian company has won a tender to build a 100-megawatt oil-fired plant at Vlore in Albania's south. It should start producing electricity in 2010.

With local elections due on February 18th, Sali Berisha, the prime minister, is under attack for letting the lights go out. Voters are poised to punish his Democratic Party for not delivering on its promise at the general election in 2005 to clean up KESh and provide cheap, year-round power. Last month he made a joint appeal with Sergey Stanishev, his Bulgarian counterpart, for units 3 and 4 at Kozloduy to stay open (units 1 and 2 are already closed; units 5 and 6 are more modern and safer). Bulgarians argue in Brussels that Balkan countries need as much energy as the region can produce if they are to grow faster.

Andris Piebalgs, the EU energy commissioner, is not convinced. On February 1st he told Mr Berisha that instead of teaming up with the Bulgarians to demand special treatment he should do more to sort things out at home. This was not quite the pre-election response Mr Berisha had been hoping for.

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Italian football

# An unflattering reflection

Feb 8th 2007 | ROME
From The Economist print edition

**A tragic death may yet lead to reform**

IF SPORT mirrors society, then Italian football, amid national soul-searching over the death of a police officer following a soccer riot on February 2nd, surely reflects the country's wider woes. Italy brims with talent. Its footballers won the World Cup last year. Its manufacturers enjoy a global reputation for flair, but their efforts are persistently hampered by flaws in the society in which they operate, notably corruption. Out of 163 nations in Transparency International's 2006 corruption perceptions index, Italy ranked 45th, beaten only by Greece in the "old" EU. Football confirmed the perception with a scandal last year showing games in Serie A (the top division in the professional championship) were rigged to ensure richer sides won. Stiff penalties for the wrongdoers have since been watered down.

The latest events have spotlighted the role of the militant or "*ultra*" fan clubs, responsible for the stadium violence. They have secured extraordinary power for themselves. They run local radio stations. Their leaders receive tickets to resell at a profit. Some move freely in and out of the players' dressing room. Others travel to matches on their clubs' private jets.

Such is the arrogance of the *ultras* that, like the Sicilian Mafia in the 1990s, they feel ready to challenge the state. Instead of fighting each other, they battle the police.

Last week's death, at a stadium in Sicily, was hardly Italian football's first fatality: there have been 18 since 1963. But Inspector Filippo Raciti was the first servant of the state to be killed. That may help explain why, as happened after the assassination of two prominent anti-Mafia prosecutors in Sicily in 1992, the state's reaction has been unusually vigorous. The championship was immediately suspended and the government quickly agreed with sporting officials on a package of draconian measures, including a ban on the re-opening of stadiums whose security did not comply fully with the law.

This is scant assurance for the future. Guido Rossi, the lawyer-turned-businessman appointed to reform football after last year's scandal, maintains that his country's worst maladies are "the rejection of rules and an aversion to change".

In Italian soccer there is ample evidence of both. Since 1989, at least five attempts have been made to tackle the various problems of the game, including the propensity to violence by the fans. One was scrapped after lobbying by club presidents. Another was dropped for fear of infringing civil liberties. Three more were either partly or wholly ignored, including a 2005 law requiring the installation of turnstiles at stadiums and the issuing of tickets bearing the name of each spectator.

The result is that Italian clubs, like other businesses, have lost competitiveness and struggle to retain both spectators and players. Fabio Cannavaro, Italy's captain, left for Real Madrid soon after bringing home the World Cup.

So will things change? Just as Romano Prodi's centre-left government is promising to tackle the economy with a programme of liberalisation, so the interior minister, Giuliano Amato, is pledging full implementation of the 2005 law.

Like his boss, Mr Amato faces a struggle. Only four Serie A grounds comply with the law. So some of Italy's proudest sides, including AC Milan and Internazionale, could be forced to play at home to empty stadiums until the changes are made. Their presidents are determined to secure a compromise, as are the petrol-station owners who have begun a series of two-day strikes aimed at weakening Mr Prodi's liberalisation programme.

Will the government relent? “We have a duty to law-enforcement officers and the public to resist [these] pressures,” Mr Amato told parliament. If he is as good as his word, something important will have changed in Italy. And not just in football.

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Turkey's Kurds

# Let justice be done

Feb 8th 2007 | VAN
From The Economist print edition

**A human life is worth 60 sheep**

SIXTEEN years ago, Semsettin Korkmaz, a member of a government-run Kurdish militia called “the village guards”, was hunting separatist PKK rebels near Turkey's border with Iraq when his left foot was blown off by a landmine. The Turkish state, he says, offered neither medical care nor compensation, leaving him to hobble on a wooden foot that he made for himself.

Now, “thanks to Rojbin”, he feels “like a man again”. Rojbin Tugan, a 35-year-old human-rights lawyer, last year managed to get Mr Korkmaz fitted with a prosthetic foot, so adding to her reputation in Turkey's mainly Kurdish southeast as a dogged defender of the poor or oppressed. Heads turn as she enters restaurants; patrons vie to pay her bill.

Amberin Zaman

**Lawyer and client**

Miss Tugan's myriad crusades include a project to rid the mountainous terrain bordering Iran and Iraq of tens of thousands of landmines planted by Turkish security forces and PKK rebels alike during the Kurdish insurgency in the 1990s. At least 68 people—nine of them children—were killed and 152 others injured in landmine blasts in 2005 alone. When Miss Tugan is not bullying the government to demarcate mined areas, she is pressing for compensation for the thousands of villagers who lost loved ones and livestock in the armed forces' scorched-earth campaign against the PKK. Recently, she won 14,400 liras ($10,000) for a client who lost 60 sheep and 14,500 liras for another who lost a son: “For the Turkish authorities”, she notes, “a human life is worth 60 sheep.”

Miss Tugan's brush with the authorities began early. Her father, a Kurdish-rights activist, was frequently arrested, tortured and jailed. Special security forces would ransack the family home in the province of Hakkari. Incensed by such indignities, Miss Tugan resolved to become Hakkari's first woman lawyer, a dream she fulfilled in 1996.

She instantly became a target for the town's military commanders. Detained numerous times, Miss Tugan's closest shave came when she was held at the local headquarters of the secret police. Happily, an intrepid prosecutor came to the rescue, vowing to press charges of attempted murder against the general who had ordered her arrest. “He saved my life but lost his job,” she recalls.

At least for some officials, Miss Tugan is now a treasured asset, one who can help dispel fears among Kurdish women that inoculation campaigns are a Turkish plot to make them barren. But not everyone is happy. Miss Tugan continues to be threatened—including, it seems, by her former captor. Determined she may be, but she is also scared.

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**Charlemagne**

# Berlin Minus

Feb 8th 2007
From The Economist print edition

Peter Schrank

**There is no excuse for the failure of NATO and the EU to talk to each other**

IN THE post-cold-war model of saving the world, conflicts will be suppressed, and countries rebuilt, by alliances of alliances. International bodies will move into a conflict zone and parcel out the problem according to their expertise. The United Nations will supply legitimacy; NATO will break the furniture; the European Union will organise a trip to the nearest IKEA and provide development and political support; the Council of Europe will monitor elections; and the World Bank and assorted NGOs will do their thing.

So it came as a shock when the secretary-general of NATO, Jaap de Hoop Scheffer, addressing an audience in Berlin recently, characterised relations between two of these institutions as follows: “It is astounding how narrow the bandwidth of co-operation between NATO and the [European] Union has remained. There is still a remarkable distance between them.”

EU officials were furious. But they can hardly have been surprised. Mr De Hoop Scheffer blew the lid on what has been known for some time: that despite protestations on both sides about the blissful harmony of transatlantic ties, relations between two of the rich world's most important organisations have practically broken down.

This failure is all the more remarkable since the institutions, with their overlapping membership, are in some ways growing closer together. NATO is moving into EU territory; the EU into NATO's. The suits are seeking to build up a common security policy. The fatigues acknowledge that in modern conflicts, battlefield victory alone is not enough (see Iraq, *passim*).

Obviously, as the two grew closer, there had to be a division of labour to prevent duplication and to persuade America and its closest allies that the EU's defence policy was not aimed at undermining, but rather complementing, NATO. The arrangement was worked out in 2003. Called “Berlin Plus”, it laid down how and when European countries could call on NATO's assets for EU purposes.

This deal has not stood the test of time. The two most important arenas in which the EU and NATO work together jointly are Kosovo and Afghanistan. In Kosovo, according to proposals from the chief UN mediator, Martti Ahtisaari, EU policemen are about to take over from UN peacekeepers, while some 16,000 NATO troops remain. Yet no one knows how EU and NATO forces will divide their security roles and time is running out.

In Afghanistan, NATO commanders despair that troops clear an area of the Taliban, and then nothing happens: no schools are built or roads constructed, and the Taliban simply regroup. Afghan ministers say there is no co-ordination of aid from the EU. Everyone nervously awaits the Taliban's spring offensive.

Back in Brussels, home to both NATO and the EU, the Berlin Plus arrangements have been overwhelmed by a different force: EU expansion. In 2004 (ie, after the EU-NATO deal), the EU admitted Malta and Cyprus as members. Neither is a member of NATO, and Turkey, a NATO founding member, does not recognise the government of Cyprus, with which it disputes the divided island. Turkey will not let NATO exchange sensitive information with the EU (lest it go to non-NATO countries). Cyprus (population 750,000) will not let the rest of the EU engage in most discussions with NATO (population: 850m).

Hard though it is to believe, the upshot is that when EU and NATO officials meet, they may not talk about Afghanistan and Kosovo, their most significant operations. They can mill around the bar, but formal discussions are out. Two of the West's most important institutions, and two of the world's most dangerous countries, have been taken hostage by single-issue bloody-mindedness over a conflict that has lasted three decades.

EU officials say that, in reality, things are not as bad as they look. The EU and NATO worked perfectly well together in Bosnia. Commanders and officials on the ground sort out problems informally. There is a particular problem with Turkey and Cyprus, they concede, but not a general one with the EU and NATO. And they say that, unless NATO's secretary-general has some solution to this specific quandary, he should shut up.

The last point may perhaps be justified, but the rest is not. The Bosnia operation worked well, but most of the important decisions were taken before Cyprus joined the EU. It is true that NATO commanders talk to EU officials in the field. But people on the spot cannot compensate fully for differences at the top because they do not have full freedom of action. Their mandates are handed down from on high and constrain what they can do. The truth is that the impasse in Brussels has almost certainly made the Afghan operation less effective than it might have been—and the fear is that the same may occur in Kosovo.

## A truce between allies

It is also true that if you waved a magic wand and solved the Turkey-Cyprus dispute, you would go some way towards easing relations between NATO and the EU. But a clash of world-views would remain. France, in particular, sees NATO as an American vehicle, and hopes to build up the EU into a defence force that can treat with America on equal terms (forget the discrepancy in military spending for a moment). To some, the two organisations are engaged in a hidden Darwinian struggle, a zero-sum game in which what is good for NATO is bad for the EU. Seen in this light, the current arrangements between NATO and the EU look more like a truce than a permanent settlement.

Europeans and Americans profess to believe that when they act together, good things happen. Yet they cannot make the EU and NATO work properly even though 80% of EU members belong to NATO—and vice versa. What then are the chances that in future conflicts, in which a wider range of international organisations could be involved, even broader alliances of alliances will be any more successful?

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**Parliamentary reform**

# What the Lords are for

Feb 8th 2007
From The Economist print edition

PA

**A new plan to shake up an ancient assembly, and plenty of disagreement about it**

**Get article background**

WHEN pondering what a representative democracy should look like, one option the authors of America's *Federalist Papers* never entertained was to give eminent crime-writers a say in shaping the nation's laws. Yet that is what Britain's constitution currently allows: Ruth Rendell, creator of Chief Inspector Wexford, and P.D. James, who dreamt up Commander Adam Dalgliesh, are both members of the House of Lords. The place is not short of such quirks. Since there is no formal way of calling speakers, the chamber decides collectively who should take precedence, by hollering. And whereas in most bicameral systems the upper house has fewer members than the lower, the Lords outnumber the Commons by 746 members to 639. Many seldom show up.

Yet for all that, the House of Lords is currently working better than it has for a long time. On February 5th it inflicted another defeat on the government, over a bill to hold managers responsible for deaths at work. The Home Office wanted an exemption for those who die in police custody or in prison; the Lords said no. Since a newish Labour government reformed the house in 1999, removing most of the (mainly Conservative) tweed-clad hereditary peers and leaving the appointed life peers in command, the assorted businessmen, scientists, party hacks and lawyers in the Lords have defeated the government more than 350 times. They do a better job of scrutinising laws than MPs, debate more interesting subjects (on inheritance tax last week, on Chinese investment in Africa this week) and often produce better reports.

Yet even though the reforms seem to have made the Lords bolder, the system looks anachronistic and untidy. It has also landed the government in trouble for trying to give peerages to people who lent Labour money. Which is why Jack Straw, the leader of the House of Commons, published on February 7th a proposal to change the composition of the Lords again. The last time Labour tried to reform the place, four years ago, the attempt failed for lack of a blueprint and a voting system designed to produce a clear basis for change.

Mr Straw is keen for the reform to stick this time and has come up with a new way of expressing preference for different options that should lead to agreement—in the Commons, at least—on reform. Elections to the Lords, were they agreed, would probably happen at the same time as elections to the European Parliament, and like them be based on proportional representation. The peers would be pruned to 540.

Most in the Commons support an upper chamber that is at least partially elected. The Conservatives have had a clear policy in favour of a largely elected upper house for the past five years, even if plenty of their MPs feel uneasy about it. Mr Straw prefers a mixture in which half of the peers would be elected and half appointed (some, as now, by political parties), which sounds like a mess. But plenty of thoughtful people

(many of them in the Lords) are holding out for oligarchy.

“Even electing 50% of the Lords would completely ruin it,” argues Lord Lipsey, a Labour peer who once worked at *The Economist*. The expertise gathered in the Lords would, he says, be impossible to replicate with elections. Lord Steel, a former leader of the Liberal Democrats, also argues that the Lords should be appointed from among the eminent in different walks of life, even though his party has long wanted to make the place democratic (a Liberal government passed a bill in 1911 promising “a second chamber constituted on a popular instead of a hereditary basis”). Democracy might even bring the thuggish British National Party onto the red benches. Such arguments were bolstered by a new poll by YouGov for the Hansard Society, a charity, which suggests the public do not want a second chamber dominated by political parties, a probable outcome were the Lords to be elected.

## Want an office to go with that office?

Almost all big democracies have bicameral systems (an exception is New Zealand, which did away with its Legislative Council in 1951). But not all upper houses wield the same power. Some, like America's Senate and Germany's *Bundesrat*, have real clout and can prevent bad (or indeed good) laws from going beyond proposals. Others are there merely to advise, revise and slow down the whole lawmaking process. Canada's Senate, whose members are picked by the prime minister and cannot veto laws, falls into this category, as does Britain's House of Lords. The only circumstance in which the Lords can kill a law is if the government tries to pass a bill to make parliamentary terms longer.

Powerful upper houses occur in federal states, and they are powerful because their senators are elected to represent a discrete interest. Since Britain is not federal, it is not clear whom the elected peers would be there to represent. And, without a veto, they would be in the odd position of having a mandate from the electorate but not much chance to exercise it.

If, instead of asking who should be there, the question posed is what the Lords are for, most MPs will answer that the house should remain a place “of temporary rejecters and palpable alterers”, as Walter Bagehot, an editor of *The Economist*, described it in the 19th century. Even ardent democrats like Andrew Tyrie, a Conservative MP who worries about power being concentrated in too few hands, do not want it to become a veto-wielding rival to the lower house. And only a few people on the Labour left think the thing should be scrapped altogether, which would at least be neat.

Full democracy makes sense—but only if the role of the Lords changes. There seems little point in electing new ones, paying their salaries and providing them with offices, just so they can do what the unelected lot are already doing for free.

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A soldier's death

# Mistaken identity

Feb 8th 2007
From The Economist print edition

**The row over "friendly fire" grows distinctly hostile**

ALL cases of friendly fire are distressing, but when they involve one coalition partner shooting up another, there is anger of a different order. The delay in completing the inquest into the death of Lance Corporal of Horse Matty Hull, a British soldier killed by American A10 pilots in Iraq nearly four years ago, required an expression of deep regret by Tony Blair on February 7th.

The soldier's family has struggled to find out exactly how he died. A British army inquiry in 2004 found more to criticise in the incident than did its equivalent in America. Certain material was withheld from the family—most importantly a cockpit video of the moments before and after the fatal attack on Lance Corporal Hull's convoy. The Ministry of Defence (MoD) denied its existence to his widow while others in government subsequently tried to gain permission from Washington to produce it.

PA

**Man down**

Shortly before the public inquest began on January 30th, the MoD advised the coroner that because the video had been classified "secret" by the Pentagon it would not be available for use. The coroner then adjourned the proceedings in disgust—until the Pentagon was bounced into acquiescence when the *Sun* newspaper published a leaked copy of the recording on its website on February 6th.

The recording itself is horribly predictable. Pumped-up pilots—reservists eager for action before returning to base—are misled by controllers into thinking that no "friendlies" are operating in the area beneath them. The pilots convince themselves that the orange panels that mark the vehicles as allies are in fact Iraqi rocket-launchers and begin the attack. Fear and remorse follow when they realise their mistake and its probable consequences.

The row comes at a difficult time in the special relationship between Britain and America. Even supporters of the Iraq war feel let down by the Bush administration's handling of its aftermath. This incident also revives memories of a similar tragedy in the first Gulf war, when nine British soldiers were killed by an American A10.

Nor does Britain's MoD escape unscathed. Not only is it accused of withholding evidence; it is also criticised for failing to produce something more sophisticated than fluorescent markers to protect its vehicles from friendly fire.

That last charge may be a little unfair. Identify Friend or Foe (IFF) systems for ground forces are still a few years away. And since 2004 the MoD has been trying to find the money to allow British forces to operate effectively within America's command and control structures. But whatever the technology, the fog of war and the accidents it brings will never be entirely eliminated.

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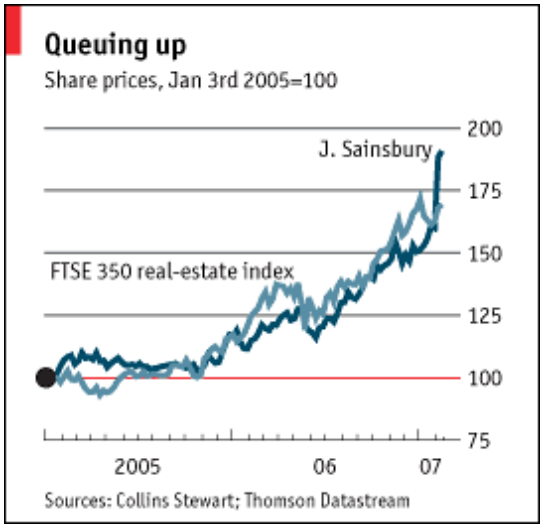
Sainsbury's

# A trolley too far

Feb 8th 2007
From The Economist print edition

**Barbarians at the check-out as private equity prepares to pounce**




"EXTRAVAGANCE", said his critics, who predicted failure when John James Sainsbury in 1882 covered the walls and counters of one of his early shops in rich brown and green tiles, layering the counter-tops with Italian marble. But where his detractors saw squander, Mr Sainsbury's customers saw cleanliness and freedom from that great bane of Victorian-era shopping: the risk of taking home a mouse with the eggs and milk.

More than a century later the family firm faces a similar dilemma—whether to invest for the long term or manage for cash in the short term. On February 2nd three of the big names in private equity, CVC, KKR and Blackstone, said they were considering a bid for J. Sainsbury, Britain's third-biggest supermarket chain. Texas Pacific Group, another private-equity firm, joined the CVC group on Wednesday. Should a formal offer be made and accepted, the deal could be worth about £9 billion ($18 billion), making it Europe's biggest leveraged buy-out to date (see article).

Sainsbury's is a tempting target. The firm churns out cash which could usefully be employed in paying off whatever debt an acquirer piled on to its balance sheet in order to buy it. But the real prize is its property portfolio, which has grown in value as commercial-property prices have risen. They went up by 18% last year alone. Selling the shops and leasing them back would not be difficult, given current demand, and it could produce more than £7.5 billion, says Greg Nicholson of CB Richard Ellis, a property consultancy.

But that carries its own risks. Sainsbury's now spends most of its cash, about £700m a year, on building new stores and refurbishing those it already has. Leasing back its shops could add about £350m to its annual rent bill, while interest payments on the debt that a private-equity buyer would probably saddle it with might well consume the rest of its cash. That would leave little margin for financing growth or just holding on if competitors slashed their margins and started a price war.

People close to the bid say that the private-equity group expects gains from more than just nifty financial engineering. They argue that the buyers would hope to widen the firm's operating margins, which, though improving, are still much narrower than those at Tesco, Britain's biggest supermarket. One way of doing that would be to cut costs. Another would be to sell goods with fatter margins such as clothes and washing machines; Tesco already makes about 20% of its income from selling such non-food items, compared with about 4% at Sainsbury's. But pursuing either strategy at a firm that is well-run already would not be easy. "It's hard to see how much more efficient Sainsbury's could be," says Tarlok Teji, head of retail analysis at Deloitte, a consultancy.

The biggest impediment to a successful deal, however, is timing. The firms circling Sainsbury's would have done better to bid two years ago, before interest rates started rising and after the company posted its first-ever loss.

Since then Justin King, appointed chief executive in early 2004, has turned around the company and halted the fall in its market share. Sales in the last quarter of 2006 were a respectable 7% up on a year earlier, compared with a 4% increase for supermarkets as a whole. That has helped lift its share price by 65% over the past year. At this level, private-equity buyers would struggle to make the returns—at least 20%—that their investors usually demand.

Clued-up institutional investors are another obstacle to the success of the deal. They are learning the wily ways of buy-out firms and some have realised that existing bosses can re-engineer their own company, shifting the gains to public shareholders rather than to private-equity investors. Sainsbury's, for instance, could easily respond to a buy-out bid by selling properties and passing the profits on to shareholders, points out Neil Darke, an analyst at Collins Stewart, a stockbroker.

Institutional investors have also learned to kick the tyres and look under the bonnet after their experience with Debenhams, a department store that was bought out in 2003 by a group of private-equity firms that included CVC and Texas Pacific. When the group re-floated Debenhams in May 2006 they quadrupled the £600m they had invested in it, partly by cutting its capital spending sharply. Those (mainly institutional) investors who took it off their hands have fared poorly: Debenhams' shares have fallen by 14% since they did. Buy-out firms may try to repeat the trick with Sainsbury's and slash spending. If they do, they will probably find themselves learning the lesson Mr Sainsbury mastered in 1882: that grocers fare best when their stores are a treat to be in.

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Bird flu

# Unruffled

Feb 8th 2007
From The Economist print edition

AFP

**Money—not health—is most at risk from Britain's first big bird-flu outbreak**

Get article background

THE relentless westward march of avian flu from its Asian home had, until last week, left Britain mostly untouched. A dead swan washed up on the Scottish coast was found last April to have died from the H5N1 strain, the most virulent version of the disease. Later that month an outbreak of the less worrisome H7 strain led to the slaughter of 35,000 chickens in Norfolk. But when on February 3rd laboratory tests confirmed that thousands of turkeys at a Suffolk farm had died from H5N1, Britain's first big outbreak had begun. Over the next few days, officials culled almost 160,000 birds that might have been exposed.

Disappointingly for a disaster-hungry media, the government seems to have handled the problem well. An early misidentification of the disease as a relatively harmless bacterial infection was quickly corrected. A restriction zone of 2,100 square kilometres (807 square miles) was placed around the farm, requiring other poultry farmers to isolate their flocks from wild birds and ask for permission before moving them. Worries that the disease might spread to humans remain just that; although a vet and a poultry worker have been taken ill with flu-like symptoms, both were later given the all-clear.

The most damaging effects are likely to be economic. The farm is owned by Bernard Matthews, one of the biggest poultry producers in Europe. Decades of homely advertising have made the company—which had sales of around £400m ($740m) last year—a household name. Yet it has been plagued of late by image problems. One of its products—the Turkey Twizzler—became a byword for the cheap junk-food fed to many British schoolchildren and was eventually discontinued. Two of its workers were convicted of animal cruelty last year.

The bird-flu outbreak has provided ammunition for opponents of industrial farming, who argue that cramped conditions make it likelier that fowl will catch a disease. Others maintain, however, that intensive farming makes it easier to keep birds away from wild animals that may carry the virus and to contain any outbreaks that do occur.

Britain's poultry producers—who earn some £3.4 billion a year—are looking fearfully at France, where a similar outbreak last year led to a 30% drop in sales. Yet so far shoppers seem unruffled. Supermarkets report no perceptible change in sales, and the National Farmers' Union says the same seems true of wholesale markets. But foreigners are taking no chances: as *The Economist* went to press 13 countries (including one EU member, Ireland) had announced restrictions on poultry imports from Britain. Total sales abroad normally bring in some £400m a year.

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**Public-sector efficiency drive**

# Flaky figures

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From The Economist print edition

**More doubts emerge about claimed savings**

EVER since the Labour government started spending like a drunken sailor, ministers have felt vulnerable to the charge that they are securing poor value for taxpayers' money. In July 2004 Gordon Brown made a pre-emptive strike by announcing an efficiency drive. The chancellor of the exchequer endorsed the aim of making annual savings of £21.5 billion by 2007-08—worth 7% of departments' current spending. The efficiency gains would be ploughed back into “front-line” public services, he said.

The target sounded ambitious, but Mr Brown's pre-budget report in December revealed encouraging progress. Annual efficiency gains already amounted to £13.3 billion. The government was thus well on the way to achieving its objective for the next financial year.

The National Audit Office (NAO) punctures the chancellor's optimism in a report published on February 8th. The auditors vouch fully for only a quarter of the economies claimed by Mr Brown. They are dubious about half the savings, which “represent efficiency but carry some measurement issues and uncertainties”. And in effect they rule out the remaining quarter of efficiency gains, saying that these either have not been demonstrated yet or may be substantially incorrect.

Even this downbeat assessment is more favourable than the NAO's first look at the efficiency drive a year ago, which concluded that all the reported efficiency gains should be treated as provisional. At that stage, many projects covered by the drive had not even established baselines against which the supposed efficiency gains might be counted. That glaringly obvious deficiency has now been put right, but doubts about the exercise persist.

For one thing, there is nothing new about efficiency drives, which featured regularly under the previous Conservative government. In a striking continuity, John Oughton, the man in charge of the programme at the Treasury, was head of John Major's “efficiency unit” between 1993 and 1997. Furthermore, a big chunk of the economies would have happened anyway because of previous investments, for example in information-technology projects that can slash costs. These savings are counted in the tally, yet the capital expenses are not taken into account.

A larger worry is whether the efficiency drive can succeed, as ministers intend, without harming the quality of public services. The indicators used to monitor quality are often too broad-brush to pick up the specific impact of the cost-saving measures. The government is cutting the number of civil servants at the departments that collect taxes and administer welfare, but this could prove a false economy if it results in revenue losses and overpayment of benefits.

What is not in question is that the target will ostensibly be met. At some stage in the next year or so, Mr Brown will trumpet the claim that the government has achieved the full £21.5 billion of savings. Sadly, few people will believe him.

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The attorney-general

# In the firing line

Feb 8th 2007
From The Economist print edition

**The top law officer's role is under challenge**

LORD GOLDSMITH, the attorney-general, is under fire from all sides. In the past week the House of Lords, the House of Commons and the Commons' select committee on constitutional affairs have all devoted special sessions to scrutinising his role. The tensions inherent in his dual responsibilities as both government minister, on the one hand, and independent guardian of the public interest and the rule of law, on the other, are no longer constitutionally sustainable, says Lord Falconer, the Lord Chancellor.

Harriet Harman, the constitutional-affairs minister, called this week for the attorney-general's normally confidential advice to government to be made public. “For public trust to be maximised, secrecy must be minimised,” she said. The Tories want a more accountable and less political attorney-general. The Liberal Democrats would like to see his functions split between an elected minister responsible for the justice system and an attorney-general outside parliament who would be in charge of prosecutions. Gordon Brown is reportedly considering a radical reform of the office if he becomes prime minister.

PA

**Fending off his critics**

The ambiguities of the attorney-general's dual role have long been the subject of controversy, not just in Britain but also in the many Commonwealth countries that have adopted a similar system. But three issues have brought matters to a head: the continuing dispute over Lord Goldsmith's secret advice to government on the legality of the Iraq war; his likely involvement in any decision to bring charges in the cash-for-honours affair; and his suspected role in the decision to drop criminal proceedings against BAE Systems for alleged bribery in its Al Yamamah arms deal with Saudi Arabia.

Lord Goldsmith continues to insist that the decision in the BAE case—which in fact was taken by the Serious Fraud Office (SFO)—was correct. In deciding whether to bring any prosecution, two factors had to be taken into account, he said in the Commons committee hearing on February 7th: the strength of the evidence and whether prosecuting would be in the public interest. In the BAE case, Saudi Arabia, a crucial partner in Britain's war against terrorism, had threatened to cut off all intelligence co-operation with Britain if investigations continued. British lives were at risk. The public interest outweighed the desirability of prosecuting alleged bribery.

Certain offences cannot be prosecuted without the attorney-general's consent. They include offences under the Official Secrets Act, international terrorism and certain types of corruption, especially those involving public officials. Which of his hats would Lord Goldsmith don if the Crown Prosecution Service decided to prosecute ministers in the cash-for-peerages matter, MPs asked: that of loyal cabinet colleague or independent law officer? Lord Goldsmith repeated his pledge to seek advice from independent legal counsel and to publish that advice in full in the event of a decision not to prosecute.

His reply nevertheless amounted to an admission that his role can involve serious conflicts of interest, and this is an increasing problem as his role is perceived to be growing more politicised. Opposition politicians point out that former attorney-generals used to attend cabinet meetings only by invitation, whereas the present incumbent is there for virtually every session. Lord Goldsmith has replied, not entirely convincingly, that as a career lawyer rather than an elected MP, he has, if anything, a lower political profile than most. “My main duty is to the law, not to party politics,” he insisted this week. “I make decisions that my colleagues don't always agree with.”

Stressing that aspects of his job had always been controversial, he admitted this week that there was “room for improvement”. His accountability to the House of Commons could be strengthened; his oath of office should reflect his various functions more clearly; but he fiercely opposes any radical change to his office. With even his own colleagues turning against him, that looks like wishful thinking.

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**Regenerating Blackpool**

# The last resort

Feb 8th 2007 | BLACKPOOL
From The Economist print edition

**The super-casino gamble failed. What next?**

BLACKPOOL'S seafront is not the most tempting destination for a winter break. But the chill has not deterred one elderly couple, who have been coming once a fortnight from nearby Rochdale for more decades than they can remember. “It's the best place in England, this,” they say. “But it could do with a lick of paint.”

Last week Blackpool narrowly missed out on a facelift worth £450m when it lost its bid to host Britain's first super-casino. An advisory panel chose nearby Manchester for the dubious honour instead. It surprised everyone, including the television crews who were waiting in Blackpool to film the joyous reaction that wasn't to be.

“We feel mugged,” says David Helliwell, the editor of the local *Gazette*. His staff are sifting through more than 2,000 letters from readers to pass on to Tessa Jowell, the culture secretary who endorsed the panel's decision, demanding that the recommendation be reversed. The area's four MPs are due to meet her soon too, though few expect her to change her mind. Nor is it likely that Parliament will overturn the decision.

Most Britons are lukewarm about the super-casino, but in Blackpool it was seen as a lifeline. Less than two decades ago the Victorian working-class playground drew as many as 17m visitors a year, but these days it struggles to stay above 10m. Cheap package holidays to warmer climes sucked away many families in the 1980s, and big northern cities such as Leeds and Newcastle cornered the “weekend-break” market in the 1990s.

Fewer tourists have meant fewer jobs. Between 1994 and 2005 the number of registered businesses in Blackpool slipped by 6%, though businesses across the country increased by 15%. Most of the victims were small guesthouses. Unemployment now stands at 7% and wages have sagged. In 2002 the average Blackpudlian was paid 17% less than the average Briton; by 2006 the gap was 23%.

Despite the dwindling numbers of visitors, Blackpool's infrastructure seems to have locked it into continuing dependence on tourism. Whole streets are given over to guesthouses (with 70,000 beds, Blackpool equals Madrid in capacity) and there is little space for new building (after Portsmouth, the borough is the most densely developed outside London). This is partly what makes the casino decision such a sore point, says Alan Cavill, head of development on Blackpool's council. Leisure tourism is the town's one strong suit—why give a big leisure attraction to a city such as Manchester that has many other options?

Locals can take some cheer from a big lump of money that is going into developing Blackpool's surroundings. The seafront will be remodelled with £75m of government cash, plus £8m from the regional development agency to dress it up. With luck (and Blackpool is due some), a further £24m of lottery funding will provide the beach with a gaudy artistic show, which Mr Cavill promises will continue Blackpool's tradition of “challenging the boundaries of good taste”. The seafront tramway is also due to be revamped.

These projects should go some way towards providing the missing lick of paint. What remains to be found is a big chunk of private investment to get people into the town in the first place. A casino alternative remains elusive, but possible candidates include an indoor rainforest, a covered ski slope and a new branch of Legoland, a Danish theme-park chain.

Whatever projects come to fruition, Blackpool landladies—legendarily tough—are finding ways to manage the decline. Pat Stokes, who runs the Mar-Ray guesthouse on Springfield Road, keeps her nine bedrooms full, thanks to her two new websites. She is not bothered about the casino, she says; most of her

customers are regulars. The traditional arcades are also wising up. Warwick Tunnicliffe, whose family has been in the amusements business since 1881, saw the writing on the wall in the 1980s and upped sticks from the touristy seafront to the town centre. Now, he reckons, 95% of the money in his slot machines comes from locals, sheltering him from seasonal ups and downs.

New types of visitors are also helping to buoy Blackpool's economy. Along the promenade, bars and strip-clubs illustrate the rise of the lucrative stag- and hen-night market. Gay tourists have also proved a hit, as the rainbow flags running down Lord Street testify. Yet tradition endures: come lunchtime, Burger King, Bella Pasta and other modern pretenders are quiet. Everyone is in Harry Ramsden's, eating fish and chips.

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**Bagehot**

# The real Labour funding crisis

Feb 8th 2007
From The Economist print edition

Steve O'Brien

**Labour's renewed dependence on the unions will cost it more votes than the police inquiry**

THE lunacy that gripped parts of the Labour Party and even more of the media late last week has abated. There may have been good arguments for Tony Blair to step down earlier than he intends—in mid-summer—but there were none for the prime minister to be hounded from office because of the drawn-out police investigation into the alleged sale of honours.

Charges have yet to be brought against anyone; indeed the first person arrested in the matter has explicitly been let off. Not even the leak-happy police have suggested that Mr Blair himself is in the frame. Nor should Mr Blair resign if Assistant Commissioner Yates does eventually collar one or two of his aides, as some have suggested is likely. His resignation would be so widely taken as an admission of their guilt that it is hard to see how the cases against them could be handled without prejudice.

Another reason why Mr Blair's party should calm down is that there is not much evidence that the police inquiry and the media hue and cry are having any impact on Labour's electoral prospects. A Populus poll for the *Times* based on fieldwork conducted last weekend found that Labour was up on the month by one point, whereas the Tories were down by three.

The notion peddled by some of Mr Blair's panicky colleagues that this sad little affair is having a uniquely "corrosive" effect on politics in general and trust in the government in particular underestimates both the intelligence and the deeply embedded cynicism of voters. Nearly three-quarters of those polled agreed with the statement that, when it came to a link between donations and peerages, Labour was no worse than past Conservative governments. Nearly half also thought the police investigation had been heavy-handed and too prone to leaking.

The real long-term damage to Labour, as the wily Tories have realised, is likely to come from a different quarter. In the run-up to the 2005 election, and in order not to be outspent by what seemed a re-energised Conservative Party, Labour not only secured loans from wealthy individuals but also negotiated a peace treaty with its traditional paymasters—the unions.

The Warwick agreement averted the threat of mass disaffiliation by the unions, and with it the disappearance of vital party funding. But in exchange the government committed itself to a wish-list drawn up by union leaders, all the while insisting that it would have implemented many of the measures anyway.

That is debatable. Promises to eradicate the “two-tier” workforce (in which privately employed workers delivering public services were paid less than their public-sector counterparts) and to impose strict limits on private-sector involvement in the National Health Service were bound to make public-service reform harder and more expensive to achieve. The impact of these and other pledges was to chip away at labour-market flexibility while adding to the costs and regulatory burden of employers.

One direct consequence of the Warwick agreement was the government's U-turn on public-sector pensions in 2005. Despite a policy of gradually raising the retirement age in line with increasing life expectancy, Alan Johnson, a former union leader who was trade and industry secretary at the time, caved in to union demands that existing public-sector employees still retire at 60 with their generous final salary pensions. In doing so, he added, by some calculations, about £1 billion ($2 billion) a month to the government's unfunded pension liabilities.

If that was bad, there may be worse to come. Sir Hayden Phillips, a former civil servant whom Mr Blair asked last year to review party funding, is struggling to forge the cross-party consensus needed to provide political cover for a hefty increase in state subsidies. Sir Hayden's problem is that the Tories have not budged from their position that all donations—whether from companies, trade unions or individuals—should be capped at £50,000. Labour, for its part, argues that the party and the unions are umbilically joined and that the affiliation fees based on union membership cannot be treated like other sorts of donation.

There are good and bad arguments on both sides. But the bottom line is that since the police began their inquiries Labour's financial dependence on the unions has become absolute. In 2005 unions accounted for 57% of Labour's donations. In the first nine months of last year their share had risen to 78% and the latest figures, from the Electoral Commission's register of donations, suggest that it is now running at nearer 90%.

According to Sir Hayden's calculations, between 2002 and 2005 a £50,000 cap on donations would have left Labour with £6.4m a year less (because much of its money comes in large chunks from the big unions), but the Tories with a reduction of only £1.7m. Given recent trends—not just Labour's growing reliance on the unions but also the Conservatives' success in raising £50,000 sums from hundreds of affluent supporters—the Tories' proposed cap might squeeze them even less and Labour more.

## In hock and in trouble

Gordon Brown, whose problem it will become, is a cautious man. If the parties can't agree a deal on future funding, much though he might like to, he won't risk driving through a big and electorally unpopular increase in taxpayer subsidies for them. Instead, he will try to reduce some of the Tories' financial advantage by imposing much tighter restrictions on spending, both in election campaigns and in marginal seats between elections.

But, as the Tories will be quick to point out, Labour will have effectively chosen to remain in hock to the unions. These days they represent little more than a quarter of those in employment—but union-negotiated settlements cover more than 70% of public-sector employees. Since Mr Brown's chances of winning an election will, to a large extent, hang on his ability to persuade voters that Labour is better at getting value from public services, that could prove a crippling handicap.

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Muslims and socialists

# With friends like these

Feb 8th 2007
From The Economist print edition

**An odd marriage of Muslims and secular socialists, united against America, is challenged by pundits of right and left**

Scoopt.com

AS GEORGE BUSH prepares to send more troops to Iraq, his critics all over the Western world are bringing more protesters onto the streets—and the range of people who are angry enough to fill the icy air with chants of rage seems broader, and in some ways stranger, than ever.

On February 24th, for example, gallery-goers and pigeon-feeders should probably avoid London's Trafalgar Square, on which tens or possibly hundreds of thousands of people will converge from all over Britain, and farther afield, to demand the withdrawal of Western troops from Iraq—and while they are at it, oppose the renewal of Britain's nuclear arsenal. Tourists who do venture near the square will notice the odd sociology of the anti-war movement: the unkempt beards and unisex denims of old-time street fighters rubbing shoulders with the well-trimmed Islamic beards and headscarved ladies.

This leftist-Muslim partnership exists not just on the streets, but in the protest movement's heart. Britain's Stop the War coalition, which has organised more than 15 nationwide protests and hundreds of smaller events, was largely forged by two small, intensely committed bodies—the far-left Socialist Workers Party (SWP) and the Muslim Association of Britain, which is close to the international Muslim Brotherhood. These tiny groups have co-ordinated street protests by up to 1m people.

With its combination of an American-aligned foreign policy and a large, angry Muslim population, Britain is an unusual case among Western countries. But in many other places, too, Muslim grievance has been yoked to a broader anti-capitalist or anti-globalist movement whose leitmotif is loathing of the Bush administration and all its works.

An Italian Marxist involved in the “Social Forum” movement, which organises large, disparate gatherings of groups opposed to the existing world order, puts it this way. Almost everybody in the movement shares the belief that “capitalism and militarism” (both epitomised by America) are the main challenges to human welfare. If political Islam can blunt American triumphalism, then so much the better—even from the viewpoint of those who would never dream of donning a headscarf or upsetting a sexual minority.

At the micro-political level, co-operation between angry Muslims and secular socialists is not always

smooth. In Britain, one of the offspring of the anti-war alliance has been the Respect Party, which combines a socialist platform with anti-Americanism and resistance to “Islamophobia”. But if Respect has remained small, that is partly because its core constituents are viewed warily, even within the Islamic-leftist fraternity. Many Muslim activists dislike the “control-freak” tactics they associate with the Brotherhood and its offshoots—and on the political left, the Respect Party has been eschewed by Greens and other radicals because of grandstanding by its SWP core.

And inevitably the partnership between secularists and Muslims faces hard moments. In Britain and the Netherlands, young Muslim activists (perhaps influenced by lefty comrades) have questioned their elders' harsh views on homosexuality—but they do not always win the argument. In the Netherlands, a Turkish-born Islamist, Haci Karacaer, tried to build bridges with the leftists (and gay-rights advocates) of the Dutch Labour party, only to be ostracised by fellow Muslims.

Just as Britain is the heartland of the leftist-Muslim partnership, it is also the main locus of a sharp and trenchant critique of political Islam. At its toughest, the argument of a new school of anti-Islamist leftists—mainly rehearsed on the internet—is that parts of the international left are now making as colossal a mistake as they did over Soviet or Chinese communism. They have let hatred of America and capitalism blind them to darker forces.

Two sorts of people have stressed this point: European ex-Marxists, embarrassed by their errors over Stalin, and dissident ex-Muslims from the Islamic world who have fled to the West and fear their hosts will “go soft” on their persecutors.

Last year's row over the publication in Denmark of cartoons satirising the Prophet Muhammad prompted a manifesto against the “new totalitarianism” of Islamism whose 12 signatories were in one or other of those categories. The five French-based signers included Bernard-Henri Lévy, a smooth Parisian pundit, and Philippe Val, an editor who faces a lawsuit from Muslims over the drawings.

The foundational texts of Britain's “anti-Islamofascist” movement include the Euston manifesto, so called because of the drafting sessions in a bar near a London station. This spoke of a threat from Islamism to causes that leftists hold dear, such as equality between sexes and sexual orientations. It denounces “disgraceful” alliances with “illiberal theocrats”.

Many European leftists see things quite differently, viewing Islamism as a potential ally against the American demon, and this has real consequences. In Italy, for example, the coalition headed by Romano Prodi, the centre-leftist prime minister, is under strain because its most left-wing parties are reluctant to vote more money for the American-led fight against Afghanistan's Taliban. One party, Communist Refoundation, dreams of an Afghan peace conference with the Taliban taking part.

The pundits who discuss these matters in cyberspace roll their eyes at such “appeasement”. Take the chief drafter of the Euston text, Norman Geras, a Manchester-based political scientist who grew up in white-ruled Rhodesia and still calls himself, with qualifications, a Marxist.

By studying the rise of Nazi Germany, Mr Geras says, he realised both the power and the limits of Marxist ideas: they help explain the economic forces that brought Hitler to power, but cannot explain certain “egregious forms of evil”—such as the regime of Saddam Hussein, whose downfall was an absolute imperative.

Nick Cohen, a peppery writer for Britain's centre-left media, has put flesh on the Euston manifesto's bones by listing the sins of the Islamic-leftist compact. Political Islam, he says, is not just a disaster for many causes (like feminism and gay rights) that the left cherishes; it also overturns the Enlightenment idea that diversity of opinion is desirable.

Paul Berman, a professor at New York University, is one of several Americans of liberal background who have joined the British denunciation of Islamofascism. He says the left's refusal to take sides in the internal battles of Muslim countries (between dissidents and oppressors) reflects an “angelic blindness” which mistakes violent reactionaries for charming exotica.

Such words will be shrugged off by those who see America as the main global foe. But there is a new voice in America's internal debate which might, in an odd way, embolden those who want social liberals and centre-leftists to lead the charge against Islamist authoritarianism.

Dinesh d'Souza, an Indian-born writer and hero of America's political right, uses a new book—with the

provocative subtitle “The Cultural Left and its Responsibility for 9/11”—to argue that America's “progressives” are not just soft on political Islam, they have positively encouraged it.

By being decadent in its behaviour and thinking, America's liberal elite has given ground to self-appointed foes of decadence, such as the political Islamists, Mr d'Souza says; and he sees an antidote in American-style religious conservatism.

Here's a prediction. Most people on the Western liberal left will shrug off the call by Messrs Geras, Cohen, Berman and Lévy to “wake up” to the threat of Islamism. But Mr d'Souza will appal them so much that some may make a sudden dash for the barricades and join the fight against all theocracy, including the American sort.

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Gifted children

# Bright sparks

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From The Economist print edition

**Not everyone's a genius, but don't say so in front of the children**

BY the time Laszlo Polgar's first baby was born in 1969 he already had firm views on child-rearing. An eccentric citizen of communist Hungary, he had written a book called “Bring up Genius!” and one of his favourite sayings was “Geniuses are made, not born”.

An expert on the theory of chess, he proceeded to teach little Zsuzsa at home, spending up to ten hours a day on the game. Two more daughters were similarly hot-housed. All three obliged their father by becoming world-class players. The youngest, Judit, is currently ranked 13th in the world, and is by far the best female chess player of all time.

Would the experiment have succeeded with a different trio of children? If any child can be turned into a star, then a lot of time and money are being wasted worldwide on trying to pick winners.

America has long held “talent searches”, using test results and teacher recommendations to select children for advanced school courses, summer schools and other extra tuition. This provision is set to grow. In his state-of-the-union address in 2006, President George Bush announced the “American Competitiveness Initiative”, which, among much else, would train 70,000 high-school teachers to lead advanced courses for selected pupils in mathematics and science. Just as the superpowers' space race made Congress put money into science education, the thought of China and India turning out hundreds of thousands of engineers and scientists is scaring America into prodding its brightest to do their best.

The philosophy behind this talent search is that ability is innate; that it can be diagnosed with considerable accuracy; and that it is worth cultivating.

In America, bright children are ranked as “moderately”, “highly”, “exceptionally” and “profoundly” gifted. The only chance to influence innate ability is thought to be in the womb or the first couple of years of life. Hence the fad for “teaching aids” such as videos and flashcards for newborns, and “whale sounds” on tape which a pregnant mother can strap to her belly.

In Britain, there is a broadly similar belief in the existence of innate talent, but also an egalitarian sentiment which makes people queasy about the idea of investing resources in grooming intelligence.

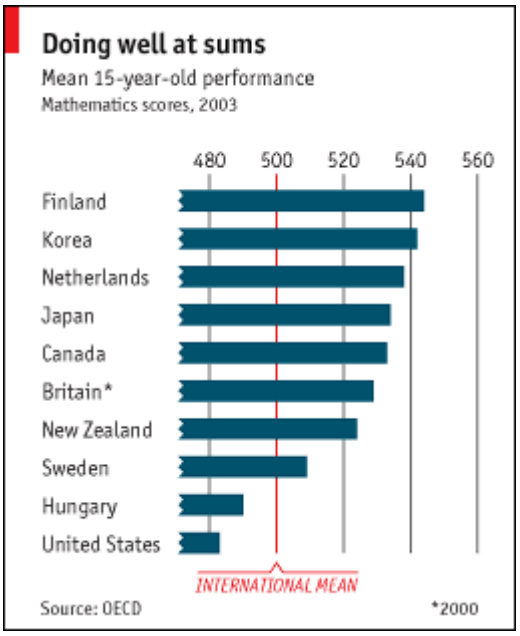
Teachers are often opposed to separate provision for the best-performing children, saying any extra help should go to stragglers. In 2002, in a bid to help the able while leaving intact the ban on most selection by ability in state schools, the government set up the National Academy for Gifted and Talented Youth. This outfit runs summer schools and master classes for children nominated by their schools. To date, though, only seven in ten secondary schools have nominated even a single child. Last year all schools were told they must supply the names of their top 10%.

Picking winners is also the order of the day in ex-communist states, a hangover from the times when talented individuals were plucked from their homes and ruthlessly trained for the glory of the nation. But in many other countries, opposition to the idea of singling out talent and grooming it runs deep. In Scandinavia, a belief in virtues like modesty and social solidarity makes people flinch from the idea of treating brainy children differently.

And in Japan there is a widespread belief that all children are born with the same innate abilities—and should therefore be treated alike. All are taught together, covering the same syllabus at the same rate until they finish compulsory schooling. Those who learn quickest are expected then to teach their classmates.

In China, extra teaching is provided, but to a self-selected bunch. “Children's palaces” in big cities offer a huge range of after-school classes. Anyone can sign up; all that is asked is excellent attendance.

Statistics give little clue as to which system is best. The performance of the most able is heavily affected by factors other than state provision. Most state education in Britain is nominally non-selective, but middle-class parents try to live near the best schools. Ambitious Japanese parents have made private, out-of-school tuition a thriving business. And Scandinavia's egalitarianism might work less well in places with more diverse populations and less competent teachers. For what it's worth, the data suggest that some countries—like Japan and Finland, see table—can eschew selection and still thrive. But that does not mean that any country can ditch selection and do as well.




Mr Polgar thought any child could be a prodigy given the right teaching, an early start and enough practice. At one point he planned to prove it by adopting three baby boys from a poor country and trying his methods on them. (His wife vetoed the scheme.) Some say the key to success is simply hard graft. Judit, the youngest of the Polgar sisters, was the most driven, and the most successful; Zsofia, the middle one, was regarded as the most talented, but she was the only one who did not achieve the status of grand master. “Everything came easiest to her,” said her older sister. “But she was lazy.”

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The World Bank and corruption

# My beautiful laundrette

Feb 8th 2007
From The Economist print edition

**A financial institution tries to practise what it preaches**

MOST big organisations wash their dirty laundry in private. Not the World Bank. On the website of its Department of Institutional Integrity, soiled garments are on full display. A photograph shows a rural road, financed by the bank, that is 30% narrower than it should be; another pictures a hut packed with children because classrooms the bank paid for are being used by a local official to store onions. This week, the department issued its first "integrity report" since 2005; it reveals a basketful of bribery, fiddles and frauds.

Insiders say the department enjoys a "mystique" among the bank's wider staff, who may have watched too many television dramas about forensic detectives. In reality, netting baddies is laborious and frustrating. Over the two years covered by this report (which ended on June 30th last year) the department fully investigated 236 allegations of corruption in the bank's projects. It was able to make charges stick in just 71 cases (and dismissed them in another 53). Those two years saw 58 firms and 54 people barred from getting bank money. The blacklist included a couple of big names, including Thales Consulting and Engineering of France, which got a wrist-slapping one-year ban.

The department also turned its lens on its colleagues, fully examining 92 allegations of fraud and corruption against the bank's staff, and substantiating 33. Some cheats fiddled taxes; others doctored expenses. One staffer charged phone-calls from one place, while claiming to attend training in another. The investigators still cite the "cancer of corruption" denounced by James Wolfensohn, an ex-president of the World Bank, in 1996. Since then, they have gained a better fix on the malignancy, they say: the same scams pop up everywhere. But they do not know their extent.

Fraud may well be rare among bank people, but endemic in its projects. Many invite bids for a contract to build a road, say, or provide tractors. The bank stumps up the cash, but the borrowing government picks the winner. In a paper published in 2005, Nathaniel Hobbs, a political scientist, shows how bids were routinely rigged. His sources had handled about 90 bank contracts, worth $90m in total, for firms in over 20 countries. In every contract, one source said, local officials sought a kick-back, typically of 10-15%.

The bank says it has "zero tolerance" for corruption in its ventures. It has a "responsibility to safeguard every dollar", says Paul Wolfowitz, the president, whose recent visit to a Turkish mosque (see picture) exposed a willingness to reveal sartorial, as well as institutional, flaws.

AFP

In any case, by one estimate the bank finances about 45,000 contracts a year. Watching every cent could cost many dollars indeed. So the bank husbands some greenbacks more carefully than others. The integrity report talks of "triage": cases implicating bank staff get its full attention, as do cases that put the bank's name at risk. It would be quick to act if scandal tainted a joint project with America's aid agency, USAID, or Britain's DfID. The department also tries to make an example of some miscreants. A seven-year ban on Lahmeyer International, a German firm convicted of bribing an official in Lesotho, seems to have scared many others.

The department saves energy by offering amnesties to wrongdoers who grass on their accomplices. It no longer waits for allegations to arrive at its door, or over its 24-hour hotline, but screens reams of contracts looking for telltale signs. Sometimes, a handful of bidders seem to take turns to win contracts. Then there are "rival" bids with identical spelling errors.

Nonetheless, the department is but a small cog in Mr Wolfowitz's general fight against corruption. Mr Hobbs thinks the bank's freedom to wage this battle is limited by a reluctance to offend and a need to lend. It cannot attack the rot at the top: that would antagonise poor countries who sit on its board and account for most of its custom. Nor can it go for the bottom—if it second-guessed every dodgy contract, it would hobble its own ability to make loans. It therefore throws punches at the flabby middle (training judges, say, or fixing procurement procedures) where the bruises do not show.

Still, Mr Wolfowitz can claim to have stepped on more toes and poked more eyes than his predecessors, delaying loans even to the biggest clients. Moreover, the department's $15m budget, though small, has tripled since 2000. His pick as director, Suzanne Rich Folsom, has more clout than her predecessor.

**All is revealed: Wolfowitz in Turkey**

But does she have the trust of the staff? The manner of her nomination prompted an objection by the staff association. An organisation that can look at employees' expenses and investigate them for tax fraud will never be popular. Some staff have been slow to blow the whistle on projects they oversaw, not wanting to embarrass host governments, or nervous of more senior loan-pushers. But field officers are more talkative now. About 30% of allegations come from staff tip-offs.

Ms Folsom wants to dispel the notion that her department investigates only the small fry. The integrity report speaks tantalisingly of a “high-stakes, and multi-dimensional” probe, still under wraps but apparently involving bank officials at the highest levels. Something to look for next time the bank displays its laundry.

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# Who are the champions?

Feb 8th 2007
From The Economist print edition

Howard Read

**European business seems stuck between awesome America and low-cost Asia. In fact it is doing surprisingly well, says Iain Carson**

IT IS not difficult to be pessimistic about the future of European business. Compared with the awesome strength of America and the raw power of emerging Asia, Europe is sometimes portrayed as a has-been, excelling in luxury goods, fine food, wines and fashion but weighed down by too many old industries and old ideas. From microchips to microbes, poor old Europe seems to trail in America's and Asia's wake.

America enjoys awesome advantages over Europe. It is a huge, truly single market with a relatively youthful, growing population. It is the world's economic superpower, with much higher productivity than its competitors (though productivity growth has recently been disappointing, and last year was slightly below Europe's). It has world-class universities that work hand in glove with business. Americans have not only won more Nobel prizes, they have turned more scientific advances into profitable businesses than anyone else. Many of these firms have gone on to become the giants of modern business.

It may have been a British scientist, Sir Tim Berners-Lee, working at a laboratory in Switzerland, who invented the world wide web, but America is the home of the internet and all the business sectors it has spawned. And even where Europe is holding its own against America, it seems unable to retain its advantage. Boeing drifted badly in the 1990s as Europe's Airbus made strides, but having merged with McDonnell Douglas the American giant bounced back. It is now taking market share from the Europeans.

America's economic growth, averaging 2.5% a year since 2001, has reflected this dynamic business culture, whereas Europe has managed an average growth rate of barely 1.5% over the same period, though the pace has picked up in the past year. Europe's sluggish performance is often put down to the poor business climate. Rigid labour laws and strong unions make it difficult for firms to fire redundant workers and unattractive to hire new ones. Product markets are not as competitive as America's, and the single European market has yet to become a reality in areas such as banking and services.

Corporate governance too is variable: transparent and world-class in Britain, but often inadequate in continental Europe. In Germany workers sit on boards, and in France even small firms have to have an employees' committee that can make life difficult for management. Minority shareholders do not always get enough say.

Moreover, European governments like to meddle. France has drawn up a list of strategic industries, including casinos, that it thinks need special protection from foreign takeovers. Even Spain, with its new Anglo-Saxon business culture, tried to stop a German utility from taking over a Spanish power company.

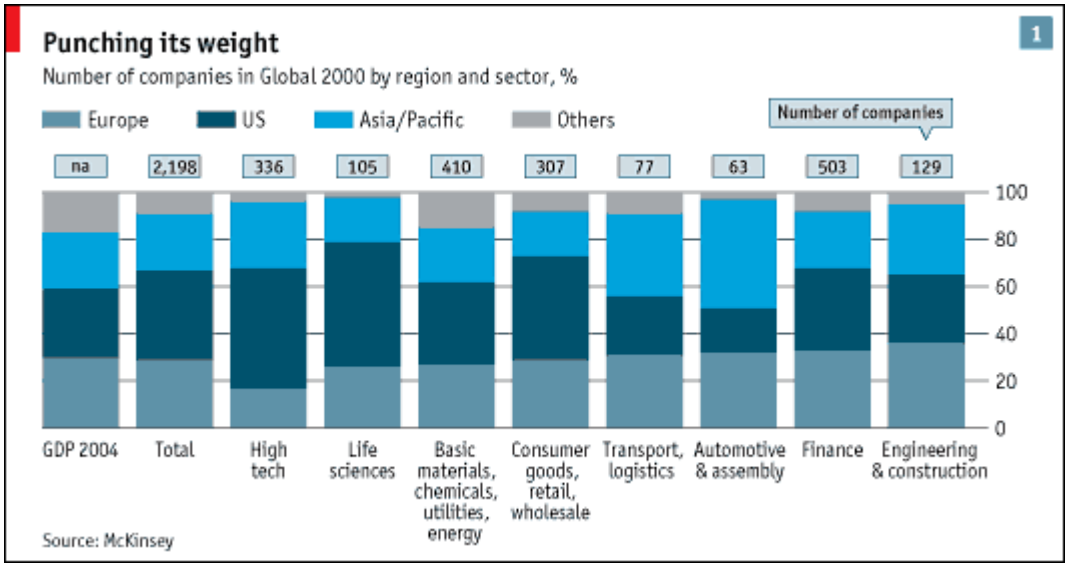
Telecom Italia's attempts to hive off its mobile-phone business became highly politicised.

Many European politicians are fearful about the effects of globalisation and the rise of China and India. France's vote against the European constitution in 2005 was partly a protest against globalisation, which is blamed for persistently high unemployment there.

Certainly Asia has been making itself more strongly felt in Europe in recent years. Japan now has car factories in France and the Czech Republic as well as in Britain, and imports from South Korea's resurgent car industry have been causing difficulties at Renault and PSA Peugeot Citroën. India's Tata Group too is planning to export cars to some southern and eastern European markets where they will provide more competition for the traditional west European manufacturers.

## Europe's pride

Yet even though European business has to operate in a difficult political, social and economic environment, it has produced an impressive crop of world-class companies. An analysis by McKinsey, a management consultancy, shows that Europe has 29% of the world's leading 2,000 or so companies, broadly in line with its 30% share of world GDP. It punches its weight in most global industries except IT, where America is leagues ahead (see chart 1).




British companies were pioneers of globalisation, perhaps because of Britain's open Anglo-Saxon business culture and financial system. More recently Britain's BP bought several American oil companies, triggering a wave of oil mergers in America and Europe. But then Britain is closer than its European cousins to the freewheeling American business model, which is why this special report will concentrate mainly on continental Europe.

Over the past few years those continental European countries have been gradually shedding their old corporatism and learning new tricks from the Anglo-Saxons. Jeff Immelt, who succeeded Jack Welch at the helm of GE five years ago, is struck by the vast improvement in European top management in recent years. As he points out, most big European businesses are now successfully global. The figures bear out Mr Immelt's impressions.

Kevin Gardiner, head of global equity strategy at HSBC, an investment bank, who first spotted the Celtic Tiger miracle of the Irish economy a decade ago, has recently made another remarkable discovery: European businesses are making better profits than their American counterparts (see chart 2). He notes that “currently European companies seem to be slightly more profitable even than their American peers.” This has been achieved even though revenues have been growing more slowly than in America, which underscores Europe's growing success in restructuring and consolidation. Corporate America and corporate Europe are now neck and neck in the globalisation stakes.

Dominic Casserley at McKinsey's London office also takes a bullish view. “Write off Europe at your peril,” he says. “In many sectors European companies are clearly in the premier league.

We see a generation of strong European management teams emerging who are aggressive, hungry and eager to expand."

Some of this revitalisation of European business is due to the impetus from a more open trading system in a global economy. European companies, small as well as large, have quietly got on with moving many of their operations abroad where it makes economic sense to do so.

But two other powerful forces are also at work. One is the structural change now taking place in Germany. After years of languishing, Europe's biggest economy is beginning to feel the benefit of reforms, particularly to its financial system.

The other force is a gush of private-equity finance, much of it originating in America and landing in Europe. This started only a few years ago, but already private-equity and venture capital invested in Europe totals €173 billion ($225 billion) and is growing by leaps and bounds.

Donald Gogel, the boss of Clayton, Dubilier & Rice, an American private-equity firm, sums up the benefits: better governance; a more stable shareholder base; upgraded management talent; higher expectations; and a sense of urgency. Private equity gives the owners of the business direct control over its performance. If managers succeed, they earn a lot of money. If they fail to perform, they are replaced. Americans have known all this for a while, but Europeans are learning it fast.

This special report will ask how European companies, large and small, are coping with global competition. It will examine the boom in cross-border mergers and takeovers in Europe and look at the fundamental changes in German business. And it will argue that European business is better than its reputation.

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# Tomorrow the world

Feb 8th 2007
From The Economist print edition

## European companies face competition from new directions

Howard Read

UNTIL late last year Arcelor was Europe's largest steelmaker. It was a European champion forged from the merger of France's Usinor, Luxembourg's Arbed and Spain's Aceralia in 2001. Today it is the core of the world's largest steel company, with production of about 100m tonnes. It was taken over by Mittal, a Dutch-registered company run from London by its biggest single shareholder, Lakshmi Mittal, an Indian who started his first business in Indonesia. The takeover battle raged for six months before Arcelor's bosses finally listened to shareholders who wanted the board to accept Mittal's third offer.

The story tells us two things about European business, both positive (though they may not seem so at first sight). First, shareholder activism is increasing in a continent where until recently it was depressingly rare. (Two other recent examples come from Germany, where shareholders of Deutsche Börse forced the board to scrap a bid for the London Stock Exchange, and France, where long-suffering Eurotunnel shareholders resorted to activism to deal with the company's debt).

Second, and more important, the Arcelor-Mittal deal demonstrates Europe's deepening integration into the global economy. A series of mergers and takeovers in the 1990s—of which Arcelor itself was an example—was meant to convert national champions into wider European champions. Now these continent-wide companies are going global, either by expanding on their own or by being absorbed into new global businesses.

The Arcelor-Mittal merger was followed barely three months later by a two-way takeover struggle for another large European steel firm, Corus, between Tata Steel of India and Brazil's CSN. On January 31st Tata won with a bid of £6.7 billion to become the world's fifth-largest steel producer. Tata's first such venture, six years earlier, had been to buy Britain's Tetley Tea. As new multinational companies emerge from economies such as Brazil, Russia, India and China, such deals will become more common. Russia is already trying to align itself with European Aeronautic Defence and Space, in which its government has a shareholding. EADS, for its part, has bought into a leading Russian aerospace firm. A Dubai company has bought Britain's biggest ports, and Sabic, a petrochemicals giant from Saudi Arabia, now owns the giant ethylene crackers and plastics factories on Teesside that were once the pride of Britain's Imperial Chemical Industries, now slimmed-down ICI.

Europe has for many years played a large part in global business. A table compiled by *Fortune* magazine shows that half the world's 30 leading companies by revenue are European (see table 3).

But in two key sectors Europe trails badly: high-tech (which mostly means IT) and life sciences. These are high-value-added industries that will weigh increasingly heavily in the world economy, so if Europe does not do well in these areas it risks falling behind.

The McKinsey analysis also shows that many European countries have a high proportion of big international companies in relation to their population (see chart 4). Little Switzerland, home to many global firms such as Nestlé, UBS and Credit Suisse, tops even America. At one point recently the board of

Nestlé did not contain a single Swiss citizen.

## Necessarily global

Given its small home market, Swiss business has always needed to be international to survive. The same goes for Scandinavia, which comes third after America. The position of the next three, Britain, Belgium and the Netherlands, partly reflects the imperial and trading heritage of these relatively small countries. Germany, Spain, Italy and Austria are all below the average for 25 European countries, though Germany has about 500 small and medium-sized (*Mittelstand*) companies that are world leaders in tiny niche markets, as well as a strong car industry and corporate giants such as Siemens and BASF, the world's biggest chemical conglomerate.

So why does America lead in the fast-growing high-tech sectors, and why does Europe hold its own only in more mature industries? Europe's computer companies of the 1960s more or less disappeared but America's survived, albeit consolidated into fewer groups. Britain's ICL, Italy's Olivetti and the Netherlands' Philips have all left the IT industry; the only surviving computer-hardware company in Europe is a joint venture with Japan, Fujitsu Siemens, and the only leading international software house is SAP. America's giants—IBM, HP, Intel, Microsoft, Oracle and Google—dominate IT globally.

**In the big league** 3

World's top companies, by revenue, 2005*, $bn

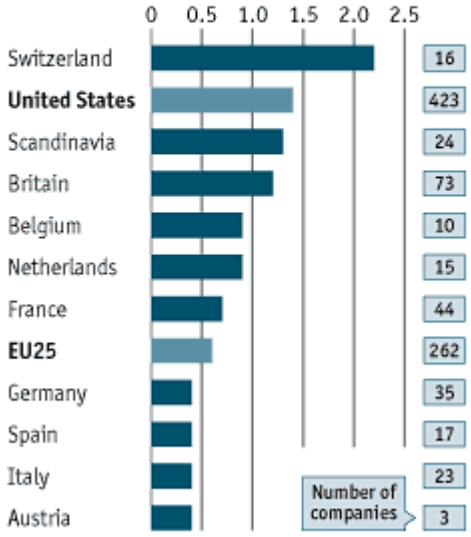
| | Revenue | Profit/loss |
|---|---|---|
| Exxon Mobil | 339.9 | 36.1 |
| Wal-Mart Stores | 315.7 | 11.2 |
| Royal Dutch Shell | 306.7 | 25.3 |
| BP | 267.6 | 22.3 |
| General Motors | 192.6 | -10.6 |
| Chevron | 189.5 | 14.1 |
| DaimlerChrysler | 186.1 | 3.5 |
| Toyota Motor | 185.8 | 12.1 |
| Ford Motor | 177.2 | 2.0 |
| ConocoPhillips | 166.7 | 13.5 |
| General Electric | 157.2 | 16.4 |
| Total | 152.4 | 15.3 |
| ING Group | 138.2 | 9.0 |
| Citigroup | 131.0 | 24.6 |
| AXA | 129.8 | 5.2 |
| Allianz | 121.4 | 5.4 |
| Volkswagen | 118.4 | 1.4 |
| Fortis | 112.4 | 4.9 |
| Crédit Agricole | 110.8 | 7.4 |
| AIG | 108.9 | 10.5 |
| Assicurazioni Generali | 101.4 | 2.4 |
| Siemens | 100.1 | 2.9 |
| Sinopec | 98.8 | 2.7 |
| NTT | 94.9 | 4.4 |
| Carrefour | 94.5 | 1.8 |
| HSBC | 93.5 | 15.9 |
| ENI | 92.6 | 10.9 |
| Aviva | 92.6 | 3.2 |
| IBM | 91.1 | 7.9 |
| McKesson | 88.1 | 0.8 |

Source: *Fortune* *Or years ending early 2006

**Small country, big welcome** 4

Number of world's top 1,000 companies

Per m people




Source: McKinsey

Hans-Paul Bürkner, global president of Boston Consulting Group, sees a clear difference in approach between Europe and America that helps to explain why American high-tech businesses are so much more successful. In the 1970s, he says, many Americans started to get out of more traditional industries and into IT hardware, software and biotech. He thinks one of the biggest obstacles to progress in Europe is a desire to preserve the status quo. But despite this conservatism, he points out, Germany has remained the world's leading exporter, with companies that put together products and services from all over the world.

In a forthcoming book, Don Sull of London Business School identifies two contrasting approaches to corporate strategy: absorption and agility. Strategic agility means that a firm is able to exploit changes in the environment faster and more effectively than rivals. Absorption describes management's way of protecting an organisation from such changes by, for instance, diversifying out of the core business or growing “too big to fail”.

The difference between the two approaches is illustrated by the most famous boxing match of the 20th century. The “rumble in the jungle”, staged in (then) Zaire, pitted George Foreman, the world

heavyweight champion, against the veteran Muhammad Ali, who was making a comeback bid. Ali's normal style was agility personified—“float like a butterfly, sting like a bee.” But faced with the younger Foreman, Ali spent six months learning to absorb heavy punishment. From round two he went defensive, leaning on the slackened ropes to absorb blows. In the eighth round, when Foreman had exhausted himself, Ali sprung off the ropes and knocked him out. His blend of absorption and agility had paid off.

As an example from the world of business Mr Sull quotes Pepsi, which uses a skilful mix of absorption and agility to try to overtake Coca-Cola. In fast-moving consumer goods, agile Procter & Gamble of America thrives on its streamlined product range whereas Europe's Unilever is panting to keep up, with too many brands in too many markets. America, by and large, stands for agility; Europe for absorption.

## When dancing elephants trip up

When stodgy European firms decide they, too, can become agile, they sometimes come to grief. ICI and GEC—at the time the twin pillars of Britain's manufacturing industry—both tried it in the mid-1990s. ICI spun off its profitable pharmaceutical business (now part of AstraZeneca) rather than build it up by acquisition. It then decided to get out of bulk chemicals and borrowed and paid too much to buy the specialty chemicals bit of Unilever. Its shares collapsed, and the company that for 70 years had been the bellwether of British industry dropped out of the index of leading companies.

John Mayo, the dealmaker who advised ICI on the Zeneca deal, also helped wreck GEC. Its defensive strategy had been to ally its power engineering and telecoms businesses with France's Alsthom and with Siemens. Guided by Mr Mayo, GEC sold its defence arm to British Aerospace and bought internet-equipment firms in America at the height of the telecoms bubble. When that burst, this supposedly agile strategy turned out to be nothing more than a flawed financial deal. BAE Systems has proved nimbler on its feet: it is reinventing itself as an American defence contractor, selling its minority stake in Airbus Industrie so it can add to its transatlantic portfolio of businesses. The attraction is that America is by far the biggest defence market, whereas the European defence business is fragmented and nationalistic.

Mr Sull observes that many European businesses are able to soldier on thanks to their bulk and solidity rather than their capacity for innovation. Many European telecoms companies are part-owned by governments to protect them. Under a special law, voting shares in Volkswagen have long been limited to 20% and a regional government has held a stake to keep the company safe (though that is set to change this year). Banks such as HSBC and ABN Amro are diversified as well as too big to fail. Europe's pharma giants—GSK, Novartis and AstraZeneca—survive as much because of their past patent rights than by virtue of their current research producing big new earners. Increasingly, however, they are moving research to America because the rewards there are greater and the environment is more stimulating.

The absorption approach works well in mature industries, but emerging economies are producing nimble companies that may prove capable of shaking up slow-moving sectors. As well as Arcelor, consider Cemex, a Mexican company that took over RMC, a British-based building-materials company; or the folding of Belgium's Interbrew into Brazil's Ambev in 2004 to form InBev. In aviation the market for regional passenger aircraft (up to 100 seats) has been taken over by two companies, Bombardier Aerospace of Canada and Embraer of Brazil. They have seen off Fairchild Dornier, Fokker and Saab from Europe because they have been prepared to introduce more innovative aircraft using modern jet technology.

Only a few years ago the railway-locomotive industry in Europe was spread among a handful of regional companies. Today, after several rounds of consolidation, it is dominated by Bombardier Transportation, another part of the Canadian group. It has based its worldwide train business in Berlin, becoming, in effect, a European global company—another example of the tide of globalisation lapping on Europe' s shores.

Forty years ago the late Jean-Jacques Servan-Schreiber, in an influential book, “Le Défi Américain”, warned Europeans that the American multinationals such as IBM, Ford and General Motors would confront them in Europe. Today it is not just American firms that are moving into Europe but companies from all over the world. And yet Europe's big companies seem to be rising to the challenge.

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# Home and abroad

Feb 8th 2007
From The Economist print edition

Howard Read

**How two European giants keep up with the global race**

SIEMENS and Philips are bastions of European business that have been global since the 19th century. By 1865 Siemens had opened up shop in Britain and was building telegraph lines all over Russia. Today it is Europe's largest engineering firm, operating in 190 countries. In the year to September 2006 it had revenues of €87 billion. Some 80% of its sales, 70% of its factories and 66% of its 475,000 workers are outside its homeland. In 2005 America became the company's largest single market, overtaking Germany.

Philips started making light bulbs in Eindhoven in the Netherlands in 1891. In the first half of the 20th century it was busy with X-ray machines and radio equipment and in the 1970s it moved into the record business. Today it employs 122,000 people in 60 countries in its diversified business.

Both these giants are prime examples of successful global European companies. They have done lots of restructuring, giving the lie to the idea that this is something European companies are incapable of doing. They have responded to the rise of low-cost manufacturing and the opening of the Chinese market by moving mass production to Asia. At home they now concentrate on the design and manufacture of high-added-value products.

Both companies have had their ups and down lately. Siemens got into a spot of bother over its handset-maker, BenQ, which it sold to a Taiwanese firm in 2005. Less than a year later the buyer shut BenQ down, with the loss of thousands of German jobs. The blame fell on Siemens, which had to pick up the €35m bill for retraining the redundant workers of a firm it no longer owned.

The company is also fighting allegations of widespread bribery that are still far from resolved. Last June it agreed to pool its telecoms equipment business with Nokia, a leader in wireless systems. The deal was announced in June, but since then Nokia executives are said to have been fretting over potential hidden liabilities from the bribery scandal. The fusion of the two businesses has been postponed. Even so Siemens reported a healthy 25% increase in profits in the third quarter of 2006, part of a continuing recovery in recent years.

Philips has been engaged in an endless round of restructuring in an effort to make it more competitive. Things came to a head in 2001-02 when the company suffered huge losses and had to shed 55,000 jobs, about a quarter of its workforce. Thirty separate divisions, each with heavy overheads, were cut down to just five—domestic appliances, lighting, medical, consumer electronics and semiconductors. A net loss of €3.2 billion in 2002 turned into a net profit of €2.8 billion in 2004, although the company has reported some poor quarterly results in the past 12 months, complicated by acquisitions and disposals. Philips has also got out of the mobile-phone business and joined forces with LG of South Korea for liquid-crystal displays, the key technology used in flat screens for TVs and computers.

Last August Philips announced that it was selling a majority holding of its semiconductor business to a private-equity buy-out led by KKR. Microchip production had been one of the pillars of its business, but high European costs and global competition persuaded it to retreat. However, only three months later Philips was back in the market, buying a Belgian firm that is a leader in advanced lighting products.

## What's new?

Christoph Loch, who teaches innovation, technology and operations management at INSEAD, a business school near Paris, thinks Europeans underrate the ability of European companies to survive globalisation. He reckons that although places such as Silicon Valley may get more attention, European companies such as Siemens have quietly been innovating and going global for decades.

Siemens systematically uses low-cost countries for making components for products that are assembled in Europe or America. But it goes further than mere offshoring of low-value-added work. It owns whole businesses, factories, service centres and distribution networks around the world, and also does much of its research and product development abroad. For instance, a lower-cost version of one of its expensive medical body scanners, tailor-made for the Chinese market, was initially developed jointly at its headquarters in Munich and in China, where it is also being manufactured; but the latest version was developed entirely in China. This Chinese Siemens product is now sold in developing countries round the world.

Klaus Kleinfeld, who became chief executive of Siemens in early 2005, says that customers are happy to buy budget scanners from Siemens rather than from, say, a start-up Chinese producer, because they know they can upgrade to the company's more sophisticated products and can stay with the same software. “They want to deal with a company that understands the future,” he says.

Mr Kleinfeld, who comes across as a rather Americanised capitalist boss, arouses strong feelings in Germany. “He is not a proper German CEO,” snorts one German manager. His public-relations staff flinch at the Rolex watch adorning his wrist. He thinks that much of the high-value development and design work in Germany will remain in Germany, but a growing part of it will join production and service facilities in countries such as India and China. He points out that India is the key to trade with much of the Middle East. “When we sell power transportation [locomotives] in the Middle East we do it through India.”

## Beautifully simple

Philips, too, is moving upmarket to survive in a world where most basic products can be made in China. Its chief executive, Gerard Kleisterlee, says that improving design across all its products is crucial to its ability to compete. Four years ago the company appointed its first marketing director for the whole group, Andrea Ragnetti, who was given the job of refreshing the company's brand to compete with cheaper products from China and South-East Asia. The idea was to concentrate on advanced products that were well designed and easy to use. Philips is well aware of consumers' growing irritation with devices that require a voluminous book of instructions.

PLI, the Belgian firm Philips acquired in November, makes sophisticated lighting systems, using LED solid-state displays. They are, well, light years away from the simple incandescent bulbs the Philips brothers made when they started the business back in 1891. LEDs offer flexible lighting that can change in intensity and colour. Philips thinks such lighting will become part of interior design. One recent Philips product, called ambilight, will even change the feel of your room lighting to suit the film you are watching.

As well as moving upmarket, Philips, like Siemens, is also making ever more of its products, or at least parts of them, in China. Its new acquisition has its headquarters in Belgium but does its manufacturing in China and Hungary. Philips itself has a long Chinese history, having first opened its doors there in the 1920s. One of its first exports to China was a personal X-ray machine for the use of the last emperor which was only recently discovered in a storage room in the Forbidden City.

These days Philips is one of the largest Western multinational companies in China, with 20,000 employees and sales of €6 billion, over half of which go for export, either as finished products or as parts for use elsewhere. Two years ago the company set itself the target of doubling sales to €12 billion this

year. Some of the €2.6 billion a year that Philips spends on R&D will also go to China, where it has 15 centres employing about 900 staff. In a speech three years ago Mr Kleisterlee said that “in some ways we consider ourselves a Chinese company.” Recently he went further, saying that “for us China is not just a workshop or a marketplace—it's a centre of innovation for new products and services with global application.”

For those Europeans who think of China as no more than an inexhaustible source of cheap labour these may be chilling words, but Mr Kleisterlee points out that three-quarters of the company's R&D is still carried out in Europe—even though over half of all Philips's manufacturing has moved abroad. He reckons that things like medical systems or fancy headlights for cars will continue to be made in Europe. But such ideas can change rapidly. In that speech three years ago Mr Kleisterlee also spoke of his company's semiconductor facilities in Hamburg and Grenoble as one of the pillars of the group. Now a majority stake in them has been sold.

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# Driving east

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From The Economist print edition

**The car may be German, but its innards are nearly all from eastern Europe**

JEAN-MARTIN FOLZ, boss of PSA Peugeot Citroën until this month, caused a stir in the late 1990s when he suggested that the Toyota factory being completed in northern France at that time would be the last car-assembly line to be built in western Europe. BMW subsequently proved him wrong by opening another assembly line in Leipzig, but Mr Folz was not far out. He himself has recently been opening plants in Slovakia and the Czech Republic and sounding the death-knell for a factory in Britain that closed its doors last month.

Peugeot is not alone in heading east in search of skilled workers at lower wages. Poland has Fiat, Opel and Volkswagen; Hungary has Audi; Romania and Slovenia have Renault; Slovakia has Volkswagen as well as Peugeot; and the Czechs have enticed Toyota into a joint venture with Peugeot.

Once you consider car parts as well as assembly lines, the rush east becomes a stampede. Peugeot's parts manufacturing arm, Faurecia, has factories in five eastern European countries as well as one in Turkey. Volkswagen adds Ukraine to give it a total of five countries. Bosch, the Stuttgart company that is Europe's leading parts-maker and one of the world's top five, has factories in ten eastern countries.

But is the rush being overdone? A study by Ernst & Young, a firm of consultants, concludes that central and eastern Europe will have a market of around 4.5m cars within five years. That sounds a lot, but it is less than a third of the 16m in western Europe. The new investment in car-assembly plants will give the eastern region a capacity of over 5.5m by 2011, making it a net exporter of vehicles. This will add to the existing overcapacity in the European car industry, currently estimated at approaching 20%.

The pain is going to be felt mostly in those parts of western Europe where up to now cars have been produced relatively cheaply: Spain and Portugal. Already Renault has slashed output at its large Valladolid plant in northern Spain, It does not take a satellite navigation system to see where the European car industry is going.

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# Buy, buy, buy

Feb 8th 2007
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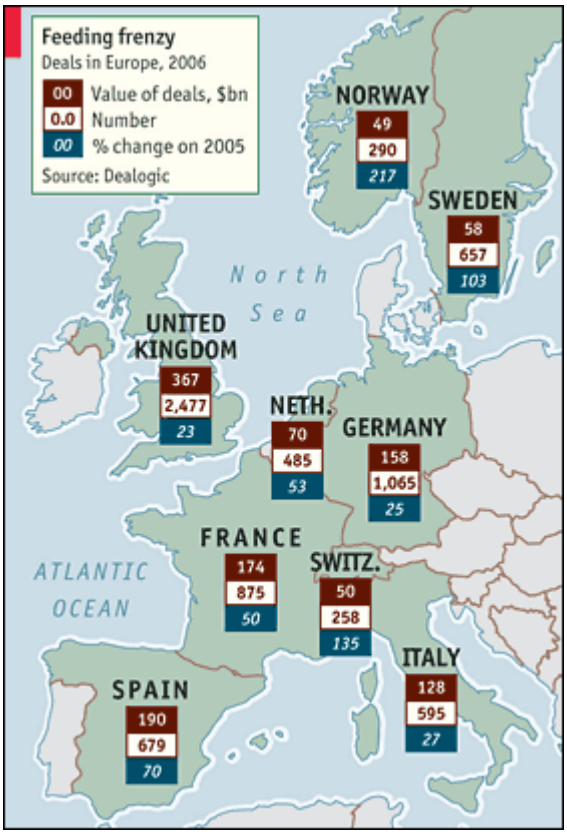
**Europe's businesses are changing hands at a record rate**




THE past two years have seen displays of the best and the worst in European business. There has been a wave of cross-border mergers and acquisitions, reflecting a healthy market for corporate control, robust profits and plenty of cheap credit. It also shows the single European market becoming more of a reality for the service sector. Utilities such as privatised energy companies are at last getting big enough to provide better service and become more profitable. More cross-border mergers mean more competition, to the benefit of consumers.

Mergers and acquisitions in Europe last year were worth $1.59 trillion, overtaking the value of deals in America (at $1.54 trillion), according to Dealogic, a data firm (see map for regional breakdown). Of the top ten deals launched worldwide in 2006 five were European, and of those two were cross-border—e.ON of Germany bidding for Endesa of Spain and Dutch-based Mittal for Arcelor of Luxembourg.

A survey by Morgan Stanley of European finance directors shows that they see mergers and acquisitions as their top priority for this year, so the recent wave of mergers—the biggest Europe has ever seen—is likely to continue through 2007. Last year Britain took the largest slice of Europe's M&A cake, with the value of deals topping $367 billion, ahead of Spain, with $190 billlion, and France, with $174 billion. Since 2004, when the current wave started to build up, the total value of European deals has almost tripled.

But there has also been a surge of economic nationalism as French and Spanish politicians have blocked takeovers of native companies by foreigners. There is some irony in the fact that Britain, which is more sceptical about European integration than most, is the most willing to permit foreign takeovers, thus promoting the integration of the single market on the ground.

France and Spain snap up foreign companies, especially British ones, but when anyone tries to do the same on their home territory their politicians put up the barriers. Italy likes to buy abroad too but closes the shutters as soon as the French or Spanish come looking. Germany, since the high-profile hostile takeover of Mannesmann by Vodafone, is coming round to the idea of foreign takeovers, just so long as the target is not Volkswagen. Recent hostility to cross-border mergers has attracted much negative comment. Paradoxically, though, it may be a reaction to the large amount of M&A that has in fact gone on unhindered.

With full liberalisation of Europe's energy market looming later this year, electricity and gas companies are seeking to become stronger before facing more competition. By contrast, consolidation in banking and telecoms has been relatively slow. There are plainly too many banks that are too weak and small, but national governments are loth to see foreigners moving in on their banks or their telecoms companies. Moreover, the French and Italian governments often retain important stakes in privatised utilities, so the scope for obstruction is vast.

The governor of the Bank of Italy resigned in 2005 after being accused of acting improperly to protect Italian banks from takeover approaches by rivals in the Netherlands and Spain. The Italian government has changed the rules about motorway concessions to prevent a friendly merger between Autostrade and Abertis, so that deal is off. The Spanish government has been doing its best to frustrate the bid for Endesa from Germany's e.ON, trying instead to promote an internal Spanish merger between Endesa and Gas Natural, a smaller local energy company.

But the most assiduous practitioners of “economic patriotism” are the French, with their list of 11 protected sectors designed to discourage predators from even considering a bid. It emerged amid rumours about a bid by Pepsico for Danone, a food group famous for its yogurt products. Again, it took only the hint of a bid for the Suez conglomerate from Italy's privatised electricity company, Enel, for Dominique de Villepin, France's prime minister, to drop his opposition to a long-planned merger between Suez and Gaz de France. Union opposition has since held up completion of the merger.

## The gain in Spain

The roof terrace outside the ninth-floor office of Cesar Alierta in the middle of Madrid affords views to the distant hills outside the city. But the personal vision of Mr Alierta, boss of Telefónica, Spain's leading multinational and its biggest telephone company, ranges even further. In the past year he assumed 100% ownership of the biggest mobile-phone company in Latin America, Telefónica Moviles, integrating it into Telefónica. In Europe he has also integrated O2, originally BT's mobile-phone offshoot, which Telefonica bought in 2005. In the first nine months of last year his company's net profit was up by 59%.

With 196m customers in Europe and Latin America, Telefónica is now the fifth-largest telecoms company in the world and the leading firm in Europe supplying both fixed and mobile services. Having conquered Latin America and secured its place in wider Europe, Telefónica last year tried for a bigger role in China, aiming for a 25% stake in PCCW, a Hong Kong telecoms company. Faced with local opposition, it had to make do with 8%.

But elsewhere Spain seems to be unstoppable. Its main hunting ground has been Britain, where Spanish companies have spent more than $55 billion in recent years, according to calculations by Thomson Financial, a data provider. The prey have been energy, utility and infrastructure firms. Many Britons now phone, bank, travel by Tube, fly out of an airport, run a tap or flush the toilet courtesy of Spanish enterprise. The first deal was when a Spanish bank, Banco Santander, which at the time was little-known, swooped on Britain's sixth-largest bank, Abbey. The latest deal in the works is the €17.2 billion bid by Iberdrola, a Spanish electricity company, for Scottish Power, a utility that includes nuclear, hydro and wind power in its portfolio.

The highest-profile Spanish deal of all, launched last year, was that of Ferrovial, a construction company, for BAA, the company that owned the three main airports serving London—Heathrow, Gatwick and Stansted—and six others. Having offered £10.3 billion ($20.2 billion), Ferrovial fought off a counterbid and persisted despite the announcement in mid-battle that the British government's competition commission would investigate BAA's monopoly with a view to breaking it up.

These airports are widely seen as a goldmine because price control on user charges is lax and the terminals offer huge opportunities for the development of lucrative retail parks. Spain's Abertis owns three other British airports, Luton, Belfast and Cardiff. Back in 2003 Ferrovial had grabbed an earlier

stake in Britain's transport infrastructure when it bought a services and project-management company, Amey, which owns two-thirds of the Tube Lines consortium responsible for running the network (not the trains) on London's Jubilee, Northern and Piccadilly Underground lines.

So why is Spain emerging as such a successful predator? It has done well out of generous European Union aid since it joined the EU in 1986. Its economy has notched up an impressive average annual growth rate of 3.8% over the past ten years when the rest of continental Europe has lagged behind at around 2.1%. Membership of the euro, says Mr Alierta, has also facilitated cross-border deals. And the latest generation of Spanish business leaders has been educated in the ways of Anglo-Saxon capitalism at American universities rather than imbibing vintage mercantilism at some French *grande école*.

There are two further reasons behind Spain's foreign expansion. One is a special law that allows companies to offset against tax 30% of the goodwill costs of any foreign corporate purchase. Goodwill means the difference between the book value of assets and the actual price paid. This allows Spanish companies to outbid others. The second reason is that Spain's resurgence has been narrowly based on an inflationary boom in property, construction and banking. When that boom busts, the gain in Spain will turn mainly into pain.

Spanish capitalism, for all its new-found foreign elan, is still a clannish affair, with banks holding locking stakes in companies and firms holding cross-shareholdings in each other, which limits the proportion of shares that float freely. A handful of leading business families—Entrecanales, March, Kaplowski and Perez—call the shots. The intriguing question is whether the new *conquistadores* have borrowed and paid too much, or whether their new portfolio of (largely) British steady earners will save them from the worst when Spain itself turns sour.

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# In the steps of Adidas

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## How smaller firms can survive globalisation

Howard Read

GLOBALISATION is daunting for many smaller firms that lack the financial and human resources to follow their customers as they move offshore. At the same time many of them are feeling the effects of globalisation in their domestic and export markets. Clusters of smaller firms in Italy and Germany that were once successful exporters have suffered as commoditised textiles, footwear and toys from China have swamped the market. They offer particularly instructive examples of how European firms are adapting to the challenges of a globalised economy.

Politicians and economists in western Europe look to small and medium-sized business to create the jobs that have gone in big companies. As the giants move production offshore, they turn their domestic operations into capital-intensive or high-added-value niche businesses that do not create many jobs. Export-minded small and medium-sized enterprises in Italy and Germany are also gradually transforming themselves, often with the help of new finance from private-equity investors; but they do not create a lot of jobs either.

Many will have to move some of their production offshore. Take Bechstein, a famous piano-maker, whose best instruments are made in a quiet little town called Seifhennersdorf, near the border with the Czech Republic. But the company has widened its product range, buying Zimmermann, an East German producer, and now makes pianos to less demanding standards in the Czech Republic, Indonesia and China. In its own way, this small company is doing much the same as giants such as Siemens, Philips or ABB, a Swedish-Swiss electrical giant. They all keep the production of core parts of their output at their home base, sometimes sending components for assembly in low-wage countries such as China. A growing number of other companies is now doing likewise.

Herzogenaurach is a town of 25,000 people in northern Bavaria, near Nürnberg, with a river running through its centre beneath a towering baroque castle. This sleepy stopover on the tourist trail hosted the Argentine football team during last summer's World Cup. It is a handy place for a footballer to be billeted because it is home to two of the world's leading sportswear companies, Adidas and Puma.

Herzogenaurach is living proof that as jobs drain away to China and other parts of East Asia, small local businesses in Europe can also go global. Adidas grew out of a little family business in the 1920s when two brothers, Adolf and Rudolf Dassler, started making leather goods in their mother's kitchen. The pair fell out in the late 1940s and Rudolf set up his own firm, Puma, to rival his brother's business, which took the name Adidas in 1948. Adidas nearly went bust in the 1980s and went through two rescue operations, sending production offshore to Asia and converting to a design and marketing company. In 1997 it bought the Salomon ski and sportswear brand, only to sell it last year as it bought Reebok to become the world's number two to Nike.

Puma was floated in 1986 but racked up losses for eight years. In 1993 it hired a new chief executive, Jochen Zeitz, a cosmopolitan brand-marketing executive from Colgate who had been educated in Italy and America. He thought Puma needed much the same treatment as Adidas. Production would have to go offshore because Germany could not possibly compete with low wages in South-East Asia. But design, product development and marketing carried on at the company's German base. For a while, after he took Puma into North America, he even moved his office to Boston to keep hands-on control of the most important expansion the company had made. Puma quickly got back into profit.

These days the company is expanding through joint ventures in Japan, China and Taiwan, as well as through subsidiaries in India and Dubai to serve the booming South Asian and Middle Eastern markets. In 2005 profit before interest and tax was around €398m on sales of €2.4 billion, with a gross trading margin of more than 50%, about the highest in the business.

Success stories such as Adidas and Puma are an inspiration to Europe's smaller companies as the winds of globalisation sweep around them. Many realise that they will have to go global, transforming themselves from manufacturing to marketing companies and keeping only 10-15% of their total workforce in their country of origin.

An hour's drive south-west of Herzogenaurach lies Göppingen, in the Neckar valley outside Stuttgart, the heartland of Germany's famous *Mittelstand.* These are the formidable medium-sized firms that helped to produce Germany's post-war economic miracle. They were financed by their local and regional banks, whose mission was to foster local enterprise. There are reckoned to be about 500 such companies that are world leaders in the tiny market niche they have chosen for themselves. Some of them, such as the Schuler metal press company in the centre of Göppingen, are suppliers to the German car and car-parts industry, down the valley where Mercedes, Porsche and Bosch have their factories.

## A model to aspire to

Michel Perraudin, who was an executive director of Adidas, is now chairman of Maerklin, a company based in Göppingen that makes model railways. It is one of the best-known brand names in the German-speaking world, beating even Coca-Cola for recognition. German men over the age of 30 get misty-eyed remembering Christmases playing with their new Maerklin train set. In the late 1990s Maerklin passed into the joint ownership of 25 family members. They were divided into three warring camps, each with an executive director, which meant there was no effective leadership and the company lost sight of its changing market. It suffered from underinvestment and its remaining 1,350 employees feared for their jobs after successive rounds of cutbacks. Revenues fell, losses rose and debts piled up.

In May last year Maerklin's banks lost patience and sold the company to a private-equity firm, Kingsbridge Capital, part of the Austrian Hardt Group but based in London's West End, the European capital of private equity. The new owners called in Mr Perraudin and Jan Kantowsky of Alix Partners, a restructuring firm, who quickly drew up plans to widen the product range and to start selling online. As Mr Kantowsky says, “We are now opening the brand to a younger customer base to kickstart growth again.” The challenge will be to keep the brand exclusive at the top end while coming up with toy trains that will appeal to today's children who are used to the speed and excitement of online computer games. Some components and simpler products will be made offshore, but many jobs will stay in Germany.

In 2005, when Franz Müntefering, then the party leader of the Social Democrats, described private-equity firms as “locusts”, Maerklin employees staged a demonstration to support the boss of Kingsbridge, Mathias Hink. A German tabloid newspaper put his picture on the front page and called him “the friendly locust”.

## Agony in Italy

On the other side of the Alps decline is evident in industries such as textiles and machine tools. Italy's main tool for controlling costs, devaluation, was removed by the introduction of the euro in 1999. For the Italian textile and clothing industry things have been going from bad to worse since China joined the World Trade Organisation in 2001. Foreign direct investment poured into China to build up production capacity for both fabrics and clothes once the country was free to export at will. Italy, which had been Europe's leading textile and clothing producer for about 25 years, felt the effect almost immediately. EU imports from China increased by nearly half in 2004 alone. In some products imports have grown sixfold and prices have fallen by a third. An emergency deal in 2005 on trade restraint between the EU and China will offer only temporary relief.

Places such as Busto Arsizio and Gallarate, north of Milan, are turning into ghost towns as firm after firm goes under, leaving empty factories boarded up. Some 30 miles to the west, in the foothills of the Alps, the same thing is happening to the cluster of woollen mills around Biella. Window grilles are rusting on the Manifattura di Valduggia, where woollen undergarments were made until the early 1990s. The Grignasco group is still turning out knitting wools, but its output halved to 2,500 tonnes in the decade to 2004 and its workforce has fallen steeply.

“We are suffering, that's for sure,” says Michele Tronconi, a mill owner who is deputy chairman of a local trade association and of Euratex, the industry's lobbying body in Brussels. “But we are still struggling, still fighting.” He has studied what has happened to the textile industry across Europe and vows not to let the Italian industry go the same way as Britain's, which more or less imploded in the 1980s and 1990s. As he sees it, the British firms grew too complacent, producing middle-of-the-road garments at middling prices for Marks & Spencer, a giant retailer. When their customer went farther afield for better quality at lower cost, much of the industry fell apart, with a few upmarket exceptions such as Pringle, a Scottish maker of woollen goods.

Mr Tronconi thinks private equity will play a role in rescuing the industry, but he is not content to leave it to outsiders. He is trying to put together a private-equity fund from among the surviving firms so that they can help each other consolidate at the top end of the market. But most mid-market clothing brands in Italy have already shifted their production to lower-cost countries such as Romania, Bulgaria and Turkey. Romania is a favourite outsourcing destination for Italians because it is relatively close and wages are around one-tenth those at home. Italians own some 1,500 textile and clothing firms there. Italy's trade minister called it “an Italian industrial province”.

The next destination is China. In the 1970s Benetton, based in Treviso in the hinterland of Venice, used to outsource garment-making to home workers near its base. In 1990 about 90% of its clothes were still produced in Italy. Now the proportion is 30%, and set to drop to 10% in a few years. The company has opened an office in Hong Kong to supervise its growing supply chain in mainland China.

Another part of Italy's survival strategy is to seek out niches in which to sell fashion items. One example is Ermenegildo Zegna, near Biella, whose brand stands for classy men's suiting. Zegna has taken to selling rather than producing in China, opening its own shops in 24 cities. It now sells 7% of its output there, about the same as in Germany. Zegna considered taking its production to China a decade ago, but decided that the advantages of Italian skills and its closely integrated production system outweighed savings in wages.

Luigi Galdabini has also considered and rejected outsourcing. He is managing director of an old-established Italian machine-tool company, Cesar Galdabini, in Varese, on the outskirts of Milan. Galdabini is famous for making small specialised metal presses. It is the world leader in the highly specialised market for pressing tools to straighten shafts used, for instance, in car transmissions. China is a new market for these specialist tools, which cannot be bought anywhere else. But at the more humdrum end of the business, smaller presses for simple metal shapes, Chinese competition is hurting Galdabini. The firm has a sales office in China and is opening a service organisation. But Mr Galdabini is reluctant to manufacture in China because he fears the Chinese will copy or steal his designs. He fumes about the CE stamp many Chinese exporters put on products to give the impression they are made to approved European standards. All it stands for, he says, is Chinese export.

He recalls that five years ago he did not see the Chinese as a threat at all. Now he worries that in another five years they will be challenging him even in the more sophisticated versions of his complex machines. The only hope, he says, is for the Italian machine-tool industry to consolidate, invest and move steadily upmarket. Like his colleagues in textiles and clothing, he and other machine-tool manufacturers are looking at setting up their own private-equity firm to help them restructure.

Germany and Italy both have strongly export-oriented manufacturing sectors with many small and medium-sized companies, often family-owned. Both are turning to private equity to help their firms deal with Chinese competition. France's exports, by contrast, are either highly specialised—eg, wine, where the competition comes from the New World rather than from China—or they are in the hands of large companies. The country's small and medium-sized companies export almost nothing. That brings its own problems.

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# The chic and the cheerless

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**Below a shiny crust of top companies, business in France is in a sorry state**

Howard Read

THE number of millionaires in South Korea, India, Russia and South Africa is rising at 15-21% a year. According to calculations by Merrill Lynch, an investment bank, the Asia Pacific area already has 2.4m millionaires, compared with 2.8m in Europe and 2.9m in America. Soon China will be producing its own contingent, in addition to those in Hong Kong. That is of considerable interest to France. Consultants at McKinsey calculate that with the number of super-rich worldwide growing by 8% a year, annual sales of French luxury goods could double to €42 billion over the next ten years.

France dominates the world market for luxury goods, with a share of 36%. Wherever the rich or super-rich pop up, they seem to want French luxury brands such as Cartier, Chanel, Hermès, Hennessy, Louis Vuitton and Moët et Chandon. Most other countries can only envy that glittering range. America has got Tiffany and not much else; Switzerland has Rolex and other expensive watches; Germany has Porsche. Only Italy offers much competition, with labels such as Armani, Bulgari, Gucci and Prada. But France's dominance goes far beyond perfumes, champagne and crystal chandeliers; just think of Dassault Falcon private jets, Catana yachts and the deluxe hotels of the Côte d'Azur. France has a leading contender in every segment of the luxury market.

Now, however, the prestigious French labels face new competition. Except for Longchamp, a fancy leather-goods company that started in 1948 and took off in the 1980s, most of France's luxury firms have been around for a long time. Still, they are doing well in new markets. Louis Vuitton, for instance, which is famous for its monogrammed luggage, has opened a dozen shops in ten Chinese cities since 1992.

In recent years, though, Italy has sprouted new luxury-goods firms to challenge France, such as Tod's and Dolce & Gabbana. In the category of affordable luxury, newcomers such as Paul Smith, a British menswear company, and Hugo Boss in Germany have come to the fore. Hugo Boss claims that one suit in six in the €700 range has its name sewn into the jacket. It has widened its product range and is particularly strong in the male-perfume business. It does not trade on being “made in Germany”, whereas for luxury goods from France their Frenchness is part of the essence of the brand.

## Trumped by foreigners

In some sectors France has lost ground. Its luxury-shoe sector is declining, not because of the cheap Asian footwear that is wiping out many European mass-market producers but because of a loss of design flair. And even French winemakers can no longer take their pre-eminence for granted. In a recent blind tasting by famous wine experts from America, Britain and France Californian wines did better than French ones, even in the higher price ranges.

France's noisy anti-Americanism suggests that France is a reluctant participant in the global economy. But half the companies in France's top 20—such as Total, AXA, Bouygues, Carrefour, Saint Gobain, Renault, PSA Peugeot Citroën and Sanofi-Aventis—are world leaders in their sectors. Most do the bulk of their business outside France. But this does not prove that France is doing as well as it might in global business. A new McKinsey study shows that the country's share of world trade in manufactured goods fell

from 6.1% in 1995 to 5.1% in 2004. Germany is doing a lot better: its companies have 6.1% of the American market, against France's 2.6%, and 8.6% of the Chinese market, compared with France's 2.2%.

Things started to go wrong for France in the mid-1990s. According to McKinsey, average annual productivity growth in 1995-2003 was only 2.1%, half the rate in 1990-95. Over the same period employment in industry fell by 5%, margins slipped by 12% and investment was down 27%. One explanation may be that France is not doing much offshoring. In 2003 imports from low-wage countries made up only 11% of France's total, compared with 39% for Japan, 35% for America, 24% for Germany and 15% for the EU 15.

But France itself, says Philippe Favre, the new boss of the official Invest in France agency, is growing more international. One French worker in seven works for one of the 20,000 foreign firms that have set up in the country; ten years ago it was one in 14. In 2005 alone 421 French companies were bought by foreigners for a total of €37 billion; most of them were medium-sized businesses rather than famous French names. Nearly half the investment in the leading share index, the CAC 40, is by foreign funds. One-third of France's exports are generated by foreign companies. A new generation of French managers is internationally respected; a Frenchman, Carlos Ghosn, is the most admired figure in the world car industry. GSK, an Anglo-American pharmaceuticals giant, is run by an expatriate Frenchman, Jean-Pierre Garnier. And a recent list of Europe's top ten business schools featured seven French establishments.

## Soft underbelly

Yet beneath the upper crust of French international companies French business is inward-looking and timid. One man who worries about this is Hugues-Arnaud Mayer, chief executive of a small French company making health-care products and head of the regional-development committee of Medef, the French employers' organisation. He thinks small business is the Achilles heel of the French economy. There are only 1m small firms, less than half the number in Germany; and some 500,000 of these are really just self-employed people. Moreover, they export far less than Germany's famously outward-looking *Mittelstand* firms. “I think this explains a great deal of our trade deficit,” says Mr Mayer. He thinks small businesses rely too heavily on local customers and are afraid to venture into the English-speaking world of exports.

According to the McKinsey study, French companies with fewer than 2,000 employees account for 99% of all companies, 70% of all jobs, 60% of industrial value added but only 50% of exports. Their operating margins average 7.8%, compared with 9.2% for big firms, which suggests that the corporate giants are better at coping with the pressures of global competition.

France needs more entrepreneurs like Stephane Ledoux, a fast-talking salesman in his early 30s who started work straight after leaving school at 18. Today he owns a specialist photo-processing company, Cité de l'Image, which employs 67 people at its labs on the south-western fringes of Paris. Mr Ledoux borrowed money and bought the business from a larger group for which he had been working. He considered moving the labs to low-wage Poland or Romania but quickly realised that would be counter-productive.

Cité de l'Image is a photo-processing and pre-press production house for an international clientele that runs from Guerlain and Yves Rocher to Xerox, Henkel and Air France. The work requires expensive, sophisticated equipment and highly skilled staff. Some simple work has been passed to Poland and Romania for overnight processing, but the core of the business has stayed in Paris. To cut costs, Mr Ledoux has outsourced functions such as IT and payroll processing. Last month a French private-equity group, Green Recovery, recruited him to run a much bigger business: the collection of photo agencies and image-processing firms (including famous names such as Gamma, Keystone and Jacana) that it had bought from the Hachette Filipacchi publishing group.

Medef's Mr Mayer has ideas about how to foster such entrepreneurialism. He himself used to be a middle manager at Abeil, a small health-care firm that was part of the big Suez conglomerate, until he borrowed money and bought the company. He wants the government and the financial sector to encourage more people to do likewise. For example, executives in big firms could get tax breaks to put aside capital for launching their own firm in the future. He thinks too many French managers are deterred from starting their own business by the red tape involved. He envies an online service set up by Portugal, not usually known for being the most entrepreneurial of places, that allows anyone to set up a company in 60 minutes.

Mr Mayer worries, too, about the future of the small and medium-sized companies that grew up in the post-war boom in France known as *les trente glorieuses*—the three decades of growth that ended in 1975. Many of these firms will simply fold as their founders retire. More generally, he is concerned about the law limiting working time in France to 35 hours a week. Although it has become more flexible, it is still a big handicap for French companies.

The Medef, chaired by Laurence Parisot since 2005, has transformed itself into a lobby group, particularly for small and medium-sized businesses. Ms Perisot is campaigning to improve industrial relations, which took a turn for the worse with the introduction of the 35-hour week. She wants further relaxation in the law to make it more flexible for small companies. Tax changes have already made France more attractive to venture capitalists and private-equity firms: it has just shot up from tenth to second place, behind Ireland, in the list of good companies to invest in compiled by the European Venture Capital Association. That is a good start.

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# Not what it was

Feb 8th 2007
From The Economist print edition

Howard Read

**European business has improved out of recognition**

WHAT with accounting scandals at Ahold and Parmalat, bribery allegations against Siemens, corruption at Mercedes, Brazilian prostitutes laid on for a Volkswagen board member and a legal challenge to a pay-off bonus at Mannesmann, European business has been having a torrid time lately. Now a criminal investigation has been launched into alleged insider share dealing at a sensitive time at EADS last spring. Meanwhile protectionism has blocked cross-border takeovers, and labour-market reforms in France and Germany have stalled.

But at the same time European business and finance has seen huge changes for the better. Europe's strength in financial services is evident not just in the City of London, which since the Big Bang liberalisation of British finance 20 years ago has expanded into the old docklands area of Canary Wharf to accommodate the flood of foreign banks that have poured into London. Strong contenders are beginning to emerge in continental Europe too. Retail banking is still too fragmented along national lines, but rationalisation in insurance has created global outfits such as France's AXA, Germany's Allianz and Italy's Generali.

Compared with America, Europe is doing very well in many service industries. Nokia, Sony Ericsson, Vodafone and Telefonica are global forces in mobile telephony. Europe's airlines make money whereas America's stagger in and out of bankruptcy. At least two failing European flag-carriers, Sabena and Swissair, were allowed to go irrevocably bust, and Air France and KLM have successfully merged. British Airways, one of the world's most profitable airlines, has a market capitalisation one and a half times that of American Airlines, the world's biggest carrier by number of passengers. EasyJet and Ryanair, two low-cost airlines, took an American business model and made it fly, and about 50 start-ups are trying to do the same. European logistics and freight giants such as DHL, TNT and Kuehne + Nagel are challenging America's Fedex and UPS.

At the same time Europe is becoming ever more integrated into the global economy, with emerging countries such as Brazil and India adding to the inward investment into the continent that has traditionally come from America and Japan. Next it will be the Chinese investing in Europe as they set up distribution and marketing networks for their own products.

European manufacturing companies too have begun to overhaul themselves. In addition to the radical reshaping at companies such as Philips and Siemens, the car industry has recast itself from a regional into a global mould, led by BMW, Mercedes and Audi. Renault became global through its partnership with Nissan and might yet be the saviour of Ford. Volkswagen is a leader in the Chinese market. Japanese and

South Korean investment in Europe is forcing local firms to match the incomers' productivity and quality. Katsuaki Watanabe, chief executive of Toyota, the world's best car company, has acknowledged that even his firm has to try harder to keep up with these new rivals. It is globalisation in action.

## It's all coming together

But the renaissance of European business also owes much to a change of climate in Germany, where many firms are now striking local deals with trade unions to get round inflexible labour practices. Workers at Volkswagen, fearful of losing their jobs, have in effect accepted pay cuts by agreeing to work longer hours for the same money. German firms are investing again after a long pause, profits as a share of national income are rising and business confidence is higher than it has been for years. Some of the reasons behind Germany's recent revival have implications for the whole continent.

The resilience of German business has allowed it to survive a dismal period for the German economy when the bills for unification came in. Germany has always had a rigorous tradition of technical education, which has suited companies concentrating on capital-intensive advanced engineering industries. The country also has a long tradition of exporting advanced products, and not just luxury cars and power stations. The world's biggest industrial-gases company is Germany's Linde; its biggest chemical company is BASF, which has defied the trend for such firms to fragment, as Britain's ICI did. There are other examples in specialist areas, such as Munich's Knorr-Bremse, the world's leading maker of railway brakes.

The struggle in the 1990s to overcome the disadvantages of a strong D-mark sharpened the competitive edge of many German exporters, whereas the Italians relied on devaluation. Since the arrival of the euro German companies have been much more disciplined than British or Italian firms about holding down wages, so they have sustained their advantage. For instance, at Opel, the German arm of General Motors, German workers have sacrificed pay and increased their productivity to hold on to their jobs, whereas the company's British factory on Merseyside has shrunk and may face closure in a couple of years. Ordinary Germans may have found the going tough in recent years, but German business has managed to retain its global competitiveness.

One reason for that may be changes in the financial sector as the country has started to move from a conservative, bank-based capitalism to a more entrepreneurial capital-markets system. The old model served German business well until the 1990s because it meant that companies had stable shareholders willing to stick around for the long term. Companies could plan and invest for the future without worrying too much about short-term ups and downs, which helped many leading German companies to develop and grow. But it has outlived its usefulness.

The new openness in the financial sector has three main causes. First, the introduction of the euro made it easier to compare the performance of different banks, exposing the German ones' low margins. Second, the Basel II accord on banks' reserve assets, due to come into effect next year, is already forcing German banks to pay more attention to the quality of their loan books. And third, the scrapping of the state guarantees enjoyed by Germany's state-owned *Landesbanken* and *Sparkassen*, at the insistence of the European Union, has acted as an incentive to banks to improve their profitability.

According to Paul Achleitner, chief financial officer in charge of investment at Allianz, German unification meant that for the first time in decades Germany needed to import capital rather than having enough to spare to export it. “Local banks stopped lending money at subsidised rates and companies needed to raise funds on the international markets. This meant they had to adapt to international norms in everything from accounting to managing for value and concentrating capital in core businesses. Slowly but surely we are seeing the dismantling of Fortress Germany; German companies are now among the most competitive in the world.”

Howard Read

The era of the stolid, traditional *Deutschland AG* (Germany Inc) is drawing to a close. According to Dirk Schumacher of Goldman Sachs, the collapse of the tech bubble and Germany's tax reform in 2000 were contributory factors. The bubble showed up the weakness in the core lending business of German banks, and the tax reform at last enabled banks to sell their long-standing shareholdings in German companies without incurring huge capital-gains tax bills.

But some observers think Germany has got it only half-right; it still

needs to reform its labour market and its welfare system. According to Hans-Werner Sinn, head of the Ifo Institute, an economic-research centre in Munich, Germany needs “more wage negotiation on the level of the firm. The majority of workers in a firm must have the right to override union decisions if they do not like them.” He also thinks welfare should concentrate on topping up low wages rather than providing a substitute income for those not prepared to work at lower rates.

## A new way of doing business

Another financial factor that has made a difference is private equity, which from tiny beginnings only a few years ago has grown into an important force. In 2005 about €72 billion was raised in new capital in Europe, well over double the amount in 2004, according to PricewaterhouseCoopers and Thomson Financial. Most of that, €57 billion, was for buy-outs of existing firms. Of the rest, €10.9 billion was for new ventures and €3.6 billion for high-tech investment.

Different countries had different preferences: in Sweden and Britain 93% of the funds went into buy-outs, whereas in Germany only 43% was used for such transactions and 26% went to high-tech firms. In Switzerland the share of high-tech investment was as much as 87%. Most of this money comes from Britain (29%) and America (24%). Pension funds are now overtaking banks as the main source of finance because they are under pressure to invest some of their funds in something other than bonds and quoted equities.

The total invested by these funds was also a record, at €47 billion, spread over more than 7,000 separate companies. About two-thirds of the money was spent on buy-outs. Venture capital aimed at business start-ups accounted for just over a quarter of total investment, but accounted for three-quarters of the deals.

Critics think that private equity can be dangerous, burdening firms with debt and stripping out cash to pay the new owners a disproportionate return. Private-equity firms are inclined to move uneconomic production offshore, breeding strong resentment about job losses. And although they will probably have a great year in 2007, those critics argue, they may not be able to maintain that performance.

Others are more sanguine, pointing to the improvements in governance and management private equity usually brings with it. It is not afraid to take difficult decisions that family-owned and listed companies often shy away from. For Dominique Senequier, the boss of AXA Private Equity in Paris, it has an important role to play in making European business more competitive. For example, this might be done by “several companies in private-equity ownership getting together and then returning to the stockmarket”, she says.

Europe's politicians may still be talking of fostering champions, but European companies are streets ahead of them. They were already beginning to reform themselves to meet global competition; now the new financial-market capitalism is giving them a further boost. That new financial underpinning will dispense with the need for the old protectionism.

Some analysts think that changes in Europe have not gone far enough and that America will always lead because its open economy provides the best example of what the (European) economist Joseph Schumpeter famously called “creative destruction”. Last year's Nobel prize-winner for economics, Edmund Phelps of Columbia University, thinks that Europe will continue to lag in productivity and innovation because it has stuck to a corporate model of capitalism that takes the wishes of government and workers into consideration. But much of European business already operates outside its home country, far from the constraints of the old corporatism—which is anyway beginning to wane. The

changes may not be as dramatic as in America, but they are reforming European industry and producing returns for shareholders to rival America's.

Although Europe will continue to lose old jobs in basic manufacturing, it will gain new ones in high-added-value industries and in services. Germany and France need labour-market reforms to introduce more flexibility, not to save old manufacturing industries but to foster new service ones. Now that global free trade is a reality and the rigid old financial structures are being swept away, things will change for the better. European business is on the move again.

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# Funny business

Feb 8th 2007
From The Economist print edition

## The tortuous tale of Telecom Italia

Howard Read

DURING the recent controversy over the future of Telecom Italia a joke was doing the rounds in Rome. How do you tell the difference between the Chigi Palace (the prime minister's office) and an investment bank? Answer: in the bank they all speak English.

The contorted tale of TI, which culminated in the resignation of its chairman, Marco Tronchetti Provera, in September, holds two lessons about doing business in Italy. First, once the government gets involved in a deal, things get murky and confusing. Second, powerful business figures seem to be able to control companies with only a tiny amount of their own money at risk.

In 2001, as chairman of Pirelli, a tyre company, Mr Tronchetti Provera borrowed a lot of money to take control of TI, in which the Italian government has a golden share. Since then TI's shares have halved in price and Pirelli's have fallen by half. Last September Mr Tronchetti Provera announced that he was going to split off TI's mobile-phone arm. This was widely seen as a prelude to the sale of the mobile business to reduce the company's huge debts. But such a sale, most probably to a foreign buyer, would have been unacceptable to the left-wing parties in the ruling coalition, especially as two of Italy's three mobile operators were already foreign-owned.

Mr Tronchetti Provera claimed that he had told Romano Prodi, Italy's prime minister, about his plans. Mr Prodi said he had had no advance warning. The prime minister's office published its minutes of two meetings between Mr Prodi and Mr Tronchetti Provera in which there was no mention of splitting TI (although the minutes contained details of Mr Tronchetti Provera's plans for broadband TV for TI of which the market had not previously been aware).

For his part, Mr Tronchetti Provera leaked a confidential paper that he had received from Mr Prodi's closest economic adviser. The paper floated the idea of selling TI's fixed-line network to a state-owned bank and also strongly suggested that Mr Prodi's office knew about Mr Tronchetti Provera's plans. Clearly one or the other of the two men was not telling the whole truth. Mr Tronchetti Provera resigned, having persuaded Guido Rossi, a veteran Italian business lawyer and the chairman of TI at the time of its privatisation, to return to the helm. This was seen as a move to stop the government from considering renationalisation. If so, it seems to have worked.

As for Mr Tronchetti Provera himself, he and his family still control Pirelli through a chain of nested stakes that give him 25.4% of the voting rights—even though he holds less than 8% of Pirelli's equity. Even after his disastrous diversification into TI, friendships and pacts with other shareholders keep him in his job. That's Italy.

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The future of television

# What's on next

Feb 8th 2007 | SAN FRANCISCO
From The Economist print edition

Claudio Munoz

**The union of television and the internet is spawning a wide variety of offspring**

BOSSES in the television industry have been keeping a nervous eye on two Scandinavians with a reputation for causing trouble. In recent years Niklas Zennström, a Swede, and Janus Friis, a Dane, have frightened the music industry by inventing KaZaA, a "peer-to-peer" (P2P) file-sharing program that was widely used to download music without paying for it. Then they horrified the mighty telecoms industry by inventing Skype, another P2P program, which lets internet users make free telephone calls between computers, and very cheap calls to ordinary phones. (The duo sold Skype to eBay, an internet-auction giant, for $2.6 billion in 2005.) Their next move was to found yet another start-up—this time, one that threatened to devastate the television industry.

It may do the opposite, as it turns out. The new service, called Joost and now in advanced testing, is based on P2P software that runs on people's computers, just like Skype and KaZaA. And it does indeed promise to transform the experience of watching television by combining what people like about old-fashioned TV with the exciting possibilities of the internet. But unlike KaZaA and Skype, says Fredrik de Wahl, a Swede whom Messrs Zennström and Friis have hired as Joost's boss, Joost does not "disrupt" the industry that it is entering. Instead, rather than undercutting television networks and producers, he says, Joost might, as it were, give them new juice.

That is because Mr de Wahl and his Joost team, working mostly in the Netherlands, have bravely ignored the totems of the internet-video boom. Chief among these fashions is letting users upload anything they want to a video service—which might include clips of themselves doing odd things ("user-generated content") or, more questionably, videos pirated from other sources. The celebrated example of this approach is YouTube, which is now part of Google, the leader in internet search. Its big problem, however, is that it can be illegal (if copyright is violated) and fiendishly hard to turn into a business.

On February 2nd Viacom, an American media giant, became the latest company to demand that YouTube remove copyright-infringing clips from its website. YouTube has struck deals with some media firms, including NBC and CBS, to allow their material to appear on its site, and had been trying to thrash out a similar agreement with Viacom. Many observers regard Viacom's move as a negotiating tactic. But whether YouTube can make money is unclear. Last month Chad Hurley, YouTube's chief executive, sketched out plans for generating advertising revenues and sharing them with content providers, but so

far his firm has none to speak of.

Joost is also ignoring the two business models seen as the most respectable alternatives to advertising. One is to make users pay for each television show or film they download, but then to let them keep it. This is the tack chosen by Apple, an electronics firm that sells videos on iTunes, its popular online store; by Amazon, the largest online retailer; and by Wal-Mart, the largest traditional retailer, which launched a video-download service this week. The other approach is to let users subscribe to what is, in effect, an all-you-can-eat buffet of videos, and then to "stream" video to their computers without leaving a permanent copy. This is the approach taken by, for instance, Netflix, a Californian firm that mostly delivers DVDs to its subscribers by post, but now also streams films.

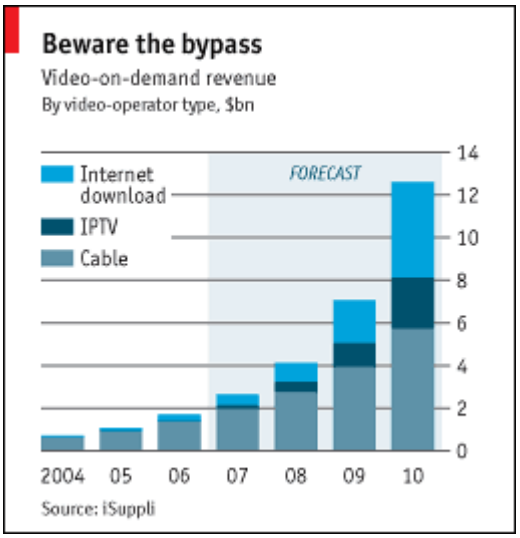
The reason that Joost is ignoring all of these methods, says Mr de Wahl, is that none has much to do with the experience of simply watching TV, which most people enjoy. Unlike the download or streaming approaches, he says, "TV is not about buying today what you want to watch tomorrow, it's about turning it on and watching." And in contrast to the "lean-forward" context of "snacking" on a YouTube clip in one's cubicle while the boss has stepped out, TV is a longer and more relaxed "lean-backward" experience.

Hence Joost's most shocking innovation, which is not to change the practices that TV adopted decades ago. It will be free, with advertising breaks—no more than three minutes per hour—either before, during or after a show, depending on the market. Americans, says Mr de Wahl, are more tolerant of interruptions.

Joost has "channels", like ordinary TV, but these are now playlists of videos that start whenever it is convenient to the viewer. Viewers can import their instant-messaging buddy lists and chat online with friends while watching the same programme. For advertisers, such engagement is worth something, because the activity proves that somebody is watching, rather than being asleep or out of the room. Combined with other information, such as the computer's IP address and hence its location, advertisers will be able to target their spots much more accurately—all "Desperate Housewives" fans in a particular neighbourhood, for example—and thus ought to pay a premium.

The thing that is missing in this new vision of television, however, is the set itself. Beaming video from a computer to a television is possible: Apple and other firms are starting to sell the necessary gadgets. But until it becomes much easier to connect televisions to the internet, big media companies are likely to "wait and see" before committing to Joost, says Jeremy Allaire, the boss of Brightcove, a rival internet-video firm based in Massachusetts. In the meantime, thinks Mr Allaire, media firms are mainly interested in building their own brands, so Brightcove provides content owners with technology to show television on their own websites, syndicate their shows to other websites, track audiences and collect advertising revenue.

There is, in short, no consensus about the best way to combine television with the internet. Instead, there are a variety of experiments, of which Joost is the latest example and YouTube the best-known. But as with telephony, the internet is unpicking service delivery from network ownership. Joost, YouTube, iTunes and Netflix do not need their own networks to supply their video services: they can piggyback on fast internet links provided by others.




According to iSuppli, a market-research firm, internet downloads will claim more than one-third of the market for on-demand video by 2010 (see chart). So just as internet telephony has been bad for traditional phone companies, this "internet bypass" could be bad for the "on demand" video services being offered by cable-TV and telecoms firms over their networks. But by bringing television to more screens in more social contexts, all this could provide new models for programme-makers to finance their productions and offer advertisers new ways to reach consumers. And so Joost and rival services could end up rejuvenating the 75-year-old medium.

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**Electronic Arts**

# Looking forward to the next level

Feb 8th 2007 | SAN FRANCISCO
From The Economist print edition

**The world's biggest video-games publisher sees good times ahead**

**The Wright stuff**

EVEN people who do not play video games themselves will probably have noticed that the latest round of the industry's three-way fight—between Sony, Microsoft and Nintendo—is now under way in earnest. The battle pitches Microsoft's powerful Xbox 360 console against the plucky Nintendo Wii and Sony's mighty PlayStation 3. Given that each round in these “console wars” lasts five or six years, it is still early days, though Microsoft and Nintendo seem to be doing better than expected and Sony, the incumbent, seems to be doing worse. But there is much more to the fight than hardware: since consoles are often sold at a loss, the real profits come from selling games. And ultimately the games, not the theoretical capabilities of the hardware, decide which console wins.

Electronic Arts, based in Redwood City, California, is the largest independent publisher of video-game software, with annual revenues of around $3 billion and a market share in Europe and North America of around 25%. Its size makes EA a reasonable proxy for the industry as whole. And with the three new consoles now on sale—the launch of the PlayStation 3 next month will complete the line-up in Europe—EA is expecting a good year.

Announcing the company's results for the last three months of 2006 on February 1st, EA executives gave three reasons for optimism about 2007: rewards, as the company reaps the benefits of investment in games for the new consoles; growth, because the company will release ten wholly owned new titles in 2007; and changing business models, due to the online capabilities of the new consoles, expansion into Asia where online gaming is particularly popular, and the rise of online micro-transactions. Each of these areas says something broader about the industry.

Like other games publishers, EA hit a bumpy patch in 2006 as gamers reduced their spending in anticipation of the switch from one generation of consoles to the next. The delayed launch of the PlayStation 3 did not help. EA launched four PS3 titles last year, but sales were lower than expected because manufacturing problems meant that Sony had fewer consoles than expected at launch. Sales of EA's two games for the Nintendo Wii, in contrast, were stronger than expected. Given the Wii's evident popularity, and its appeal to non-gamers, EA is now ramping up its development efforts for the console and intends to overtake Ubisoft of France to become the second-largest publisher of Wii games behind Nintendo itself.

EA's greater emphasis on wholly owned titles such as “Spore”, rather than the film tie-ins and sports and racing franchises for which it is best known, illustrates the way in which gaming is maturing as a medium. “Spore” (pictured) is the creation of Will Wright, one of the industry's most talented designers, whose previous hits include “SimCity” and “The Sims”. But it remains to be seen whether its unconventional gameplay will match the commercial success of his previous games.

Although it can pay the bills with franchises such as “Madden”, “FIFA” and “Need for Speed”, and film tie-ins including “Harry Potter”, EA has recently stepped up its efforts to develop its own titles. The trigger was a crisis two years ago, when overworked developers filed a class-action suit against the company. In the discussions that followed to resolve the problem, EA learnt that its developers most enjoyed working on original titles. Feedback from customers also showed that they preferred such titles to film tie-ins. Nick Earl, the general manager of EA's Redwood Shores development studio, says the shift towards more original titles has improved morale. “Coming out on the other end, we're a better company for it,” he says.

The third area where EA and its rivals expect rapid growth is in online gaming. This can generate money through subscriptions paid by players of multiplayer online role-playing games and through the sale of downloadable add-ons to console games. But online revenues are still too small to make much of a difference to EA, says Jason Kraft, an analyst at Susquehanna Financial. “If they can execute on new titles, and if PS3 sales improve, it should be a good year,” he says. And, as usual, what is true for EA is true for the industry as a whole.

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**Alstom v Bombardier**

# Train wars

Feb 8th 2007 | BRUSSELS AND LONDON
From The Economist print edition

**Sparks fly amid a railway boom**

IT IS not quite Boeing versus Airbus—yet. But France's Alstom and Canada's Bombardier, the two biggest makers of trains, are slugging it out on each other's turf and trading accusations of protectionism. The mud started flying in November when the Canadians landed a €2.7 billion ($3.5 billion) deal to supply up to 372 trains for the Greater Paris network of SNCF, the French railway operator. Alstom's boss, Patrick Kron, accuses Bombardier of dumping, with a price 10% below his offer and 15% below that of Germany's Siemens, the industry's number three. That Alstom has since been hired as sub-contractor for a third of the work has mollified Mr Kron not one jot.

He returned to the fray in Canada last month by seeking an injunction to block a deal that the city of Montreal handed without a contest to the home team. (Bombardier has its global headquarters for trains in Berlin, but the parent company is a mainstay of Quebec's economy.) Mr Kron sought an injunction to stop the firm and the municipal transport officials from even talking to each other while he mounts a full legal challenge to the deal on the grounds that it breaks Canadian law. “They get tons of money at home and then use it to dump in the international market,” he says.

All this sounds a bit rich coming from Alstom, which almost went bust in 2003 and was bailed out by the French government. The disastrous purchase of ABB's turbine business left it with dud products that undermined customers' confidence; as orders dried up, Alstom started running out of cash. But, Mr Kron points out, the European Commission forced Alstom to shed divisions with a turnover of €1.5 billion as a condition for approving the rescue—and Bouygues, a conglomerate, has since bought out the government's 24% equity stake in Alstom. He contrasts the transparent and temporary support from the French government with the covert support that Bombardier gets at home as orders are handed to it on a plate. He is particularly riled, he says, because “we are as big in Canada as they are in France”.

André Navarri, the head of Bombardier's transport business, which has factories in Germany, France and Britain, dismisses Mr Kron's attack. “We have been making trains in Quebec for 30 years and exporting them to the United States,” he says. “So it is no surprise that Montreal should turn to the local manufacturer.”

Just as Boeing and Airbus are at loggerheads in the middle of a boom for aircraft orders, the trainmakers are coming to blows at a time when railway operators are buying many more trains than usual. The worldwide open market for trains is estimated to be worth €24 billion, according to a study by Roland Berger, a German consultancy. The total railway market is about €70 billion, if you include infrastructure, signalling and control, and maintenance services.

Bombardier, Alstom and Siemens account for 55% of the train-hardware business between them, and all three are pulling further ahead of smaller producers such as Ansaldo of Italy and Spain's CAF. There are unconfirmed rumours that the makeover Klaus Kleinfeld is undertaking at Siemens might lead it to quit the train business because margins are being squeezed, possibly by selling its train division to Kawasaki or Hitachi of Japan.

Much of the growth is in Europe, where congested roads are prompting town planners to turn to light rail and trams to carry commuters. After years of concentrating on high-speed trains, the emphasis now, especially for SNCF, is on renewing antique commuter and regional rolling-stock. Deutsche Bahn is doing the same: it recently ordered 400 regional trains.

Bombardier is no stranger to international trade disputes. Its aerospace arm competes with Brazil's Embraer in the market for regional jets. Canada and Brazil both went to the World Trade Organisation complaining about each other's subsidies, prefiguring the latest row between America and Europe over aid

to Airbus. The WTO showed both countries a yellow card, but they carried on playing the same old game. Trains will be no different.

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German wine

# Better Spätlese than never

Feb 8th 2007 | GEISENHEIM
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**How German winemakers are responding to climate change**

Reuters

**Fast becoming a rarity**

JUST as Rheingau Riesling was making its mark again as one of the world's finest wines, it has come under threat from an unexpected source: climate change. The special quality of Rhine Riesling relies on a mix of cool nights and warm days for slow ripening. At the end of the 19th century Riesling wines, known as "Hock", were fetching higher prices than claret from Chateau Lafite and Veuve Clicquot champagne, according to a list from Berry Brothers & Rudd, a London wineseller. Today's Rheingau Rieslings are again winning accolades, putting the era of cheap and sickly German wines such as Liebfraumilch to rest.

But warmer average temperatures are threatening to redraw the wine map. Red-grape varieties such as cabernet sauvignon and merlot, traditionally grown in the south, will migrate northwards by 200-400km and up hillsides by 100-150 metres, says Hans Schultz of the Research Institute at Geisenheim in the Rheingau. By 2040, cabernet sauvignon will flourish where Riesling does now.

The impact has already been felt in the past few years. *Eiswein*, a delicious dessert wine made from grapes that are picked frozen on the vine at a temperature of minus 7°C or below, is becoming ever rarer. This season the local growers had only two chances—on the mornings of December 27th and January 26th—to pick grapes frozen enough. "That was our latest harvest ever for *Eiswein*," says Arno Schales, whose family has grown Riesling since 1783 and has made *Eiswein* for the past 50 years. His *Eiswein* this year, a crop of around 200 bottles instead of the usual 1,000-2,000, came from pinot noir grapes, which survived the late warm weather without rotting.

Many Rheingau growers this year gave up on *Eiswein* and instead picked the grapes for *Trockenbeerenauslese*—a wine made from grapes that have dried on the vine. German growers are also leaning more towards red grapes, though they favour the more traditional pinot noir and dornfelder varieties over merlot and cabernet sauvignon. For their part, German consumers are choosing more locally made reds than they did four years ago—27% of their red wine intake in 2006, up from 17% in 2002.

Yet the main focus is still on better and more expensive Rieslings, for which there is strong demand, particularly in America. Germany has 60% of world production, despite the advances made by America and Australia. Quality has improved as the new generation of growers has invested in better processing. But now the shifting climate is forcing them to adapt.

Mr Schultz, who has written several papers on the subject, notes that the Geisenheim vines are developing shoots seven days earlier, blossoming ten days earlier and starting to ripen 12 days earlier than the 40-year average; they are especially affected by the warmer nights. "Riesling is very sensitive to the soil and the climate," echoes Ernst Büscher of the German Wine Institute, across the river in Mainz. Whether the growers can hold their own against upstarts in Canada and points north depends on how far the climate trend continues.

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Aviation in China

# Lofty ambitions

Feb 8th 2007 | SHANGHAI
From The Economist print edition

**China hopes to build a wide-bodied airliner to challenge Boeing and Airbus**

WHEN Xu Guanhua, China's science and technology minister, listed the nation's research priorities for 2007 at a conference in Beijing last month, top of the list was the development of a wide-bodied passenger aircraft, a plan that senior officials first made public last year. In part, China is keen to develop a domestic competitor to America's Boeing and its European rival, Airbus, so as to capture part of the booming domestic market. Boeing predicts that 2,880 airliners worth $280 billion will be sold in China in the next two decades, making it the world's fastest-growing market for such aircraft. But the aim is also to foster progress in other fields, since building large airliners requires (and demonstrates) mastery of disciplines from aerodynamics to software. A formal timetable has not been announced, but officials hope China's first home-grown large aircraft will be airborne in 10-15 years.

It has a long runway ahead. Small and medium-sized aircraft, often based on Russian designs or reverse-engineered from Western models, are already made in China; some, such as the twin-propeller, 60-seater MA60, are exported to African and Asian countries. China also makes fighter aircraft, helicopters and transporters. But the depth of expertise needed to build a wide-bodied airliner is still lacking. As in other fields, the government has encouraged foreign investment to help the industry develop.

Boeing and Airbus are taking different approaches to China. Boeing's activities grew out of President Nixon's visit in 1972 and the company now buys parts from Chinese suppliers for all of its aircraft, including doors and wing panels for the 737, wing-ribs for the 747 and the rudder for the new 787. Airbus has taken a bolder step, announcing last year that it would establish a final assembly line, its first outside Europe, in the northern city of Tianjin. Production of A320 airliners, Airbus's most popular model in Asia, is expected to begin in 2009.

Smaller manufacturers, such as Embraer of Brazil and Bombardier of Canada, are also establishing ties with China. Both firms have set up production facilities in the hope of boosting sales of their regional jets, and to fend off competition from the ARJ21, a locally manufactured regional jet being developed by AVIC I, a state-owned aviation company. The ARJ21 is a 95-seater twin-jet aircraft that strongly resembles the DC-9, and is due to go on sale in 2009 after several delays. (A joint venture with McDonnell Douglas in the 1990s to build a Chinese version of the DC-9 failed.)

Diamond Air, an Austrian aircraft-maker, announced the opening of Shandong BinAo, a $42m joint venture with the government of Shandong province, at the Zhuhai Airshow in November. It will initially build under licence Diamond's DA40 single-engine planes, and later its twin-engine DA42, both of which are used to train pilots. Production is expected to be 150 aircraft this year, rising to 1,000 a year if there is demand. Pilots are sorely needed in China—each year the airlines require roughly another 2,000 of them—and flying schools are setting up in droves. Gerald Seebacher, general manager of the project, says the Chinese-built DA40s will also be sold abroad.

Airbus and Boeing do not have much to worry about yet, but China's aviation industry is developing rapidly and the goal of building a wide-bodied airliner is not out of the question. But getting such an aircraft off the ground is only half the battle. The issue is not whether the Chinese can develop the aircraft, notes AeroStrategy, a consultancy, but rather “whether they can develop one that is good enough to win against the best that Boeing and Airbus can deliver. Operational performance and reliability are two key areas.”

Another problem is certification: China's civil aviation authority would have to be officially recognised by its American and European counterparts before Chinese aircraft could be exported to America or Europe. And then there is the matter of convincing buyers that the aircraft is safe. Last month Robert Mugabe, Zimbabwe's president, was dismayed to find that his usual Boeing 737 was unavailable to take him and

his family to Asia. Air Zimbabwe offered him a Chinese-built MA60 instead—but, citing safety concerns, he refused to embark.

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Qantas Airways

# Fasten your seat belts

Feb 8th 2007 | SYDNEY
From The Economist print edition

**An attempt to take over Australia's flag carrier hits political flak**

WITH its choir of sunny-faced schoolchildren perched on top of Sydney Opera House, Qantas Airways' marketing campaign—"I Still Call Australia Home"—has proved supremely successful at tugging the heartstrings of a fiercely patriotic nation. Combining a sentimental ballad with some of Australia's most stunning landmarks, the advertisement culminates with a dramatic aerial shot of the choir standing on a pristine beach in the kangaroo formation of the airline's logo.

But the flag carrier's success in branding itself as an Australian treasure has boomeranged, after it recommended to shareholders an A$11.1 billion ($8.6 billion) takeover bid from Airline Partners Australia (APA), a consortium led by Australia's Macquarie Bank which includes Texas Pacific Group, an American private-equity giant, and Canada's Onex Corporation. Recognising Qantas's iconic status, APA has tried to put an Australian face on the consortium since launching its takeover bid in November, and has repeatedly stressed that it is Australian-controlled and thus complies with laws governing the airline's ownership. But now it has voluntarily submitted itself for approval from Australia's Foreign Investment Review Board (FIRB), a 30-day process that APA had previously argued was superfluous since the bid was not foreign.

The reason for the U-turn? Some severe election-year political flak, which could yet throw the deal off course. Much of the opposition has come, predictably enough, from the unions and a rejuvenated opposition Labor Party. The unions argue that the deal would lead to big job cuts among Qantas's 37,000-strong global workforce—93% of which is Australian—as maintenance and back-office tasks are transferred to China and India. This appeal to economic nationalism has struck a chord. Polls in a handful of marginal government-held constituencies found that 80% of respondents opposed the government's "hands-off" approach.

The ruling Liberals must also take note of the concern of their coalition partners, the rural-based Nationals. They recall the pioneering days of Australian aviation, when the Queensland and Northern Territory Aerial Services, as Qantas was then known, provided a lifeline for remote communities. Worries over the loss of regional services have prompted leading National party figures to call for a separate Senate inquiry into the deal. Other critics worry about a break-up—a bloody dissection of the "flying kangaroo".

Not everyone agrees. "Political obfuscation," cries Peter Harbison of the Centre for Asia Pacific Aviation, a consultancy. Qantas dominates the regional market, he notes, and makes more profit from it than from other routes. Regional flights also feed long-haul routes. As for asset stripping, Mr Harbison says Qantas would be foolish to divest Jetstar, its budget carrier, when the low-cost market is growing fast.

Peter Costello, the finance minister (and prime minister in waiting), will ultimately determine the government's position on whether the deal is in the national interest, and his public rhetoric so far has been suitably patriotic. "If anyone tries to lift the foreign ownership in Qantas above 49%, they will be stopped," he told reporters in Canberra this week, sternly invoking the rule established when Qantas was privatised in the 1990s. But since the APA bid has been carefully constructed to guarantee 51% Aussie ownership, and Mr Costello himself urged representatives of the consortium to put itself before the FIRB, he is widely expected to give deal the go-ahead.

He may well impose voter-friendly conditions, binding APA to safeguard routes and jobs. The challenge for APA now, as it fights to win over both the government and at least 90% of shareholders, is to navigate the deal through the smoke and subterfuge of election season.

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Managing the military

# Back to school for the admirals

Feb 8th 2007 | CHAPEL HILL, NORTH CAROLINA
From The Economist print edition

**Can business schools help the armed forces?**

“THE higher you get, most of us think we're perfect,” says Jim Shanley, a former Bank of America executive, as he hands out a form for assessing personality flaws. His scribbling students at the University of North Carolina's Kenan-Flagler Business school are not aspiring chief executives or MBAs, but three-star admirals. On this week-long programme, the first of its kind, they are learning a range of skills such as encouraging innovation, making better decisions about fleet finances and communicating more clearly.

A generation of executives cut its teeth on Sun Tzu's “ The Art of War”. America's navy has put the combat boot on the other foot, using civilian executive courses to burnish leadership. Admirals have long gone to Princeton or Harvard for foreign-policy refreshers. But Vern Clark, the Chief of Naval Operations from 2000 to 2005 and the first CNO with an MBA, made a point of sending admirals to business school. UNC now runs six courses a year for one-star admirals; last month's course was its first for three-stars. Air force officers took their first course at Kenan-Flagler last October.

How useful can this be? Commanding a submarine division, or even organising the navy's supply-chain, is very different from corporate life. Competition is not much of a factor, unless you count beating the army or air force for tax dollars. Building ships takes 17 years, and they need to last another 50—a time horizon that would confound most investors. And admirals switch jobs often. In the worst case, they may get a call on a Friday and be expected at a new desk on Monday—not at all like the corporate world (unless the boss gets the boot).

“The economics of what you learn in business school are not necessarily the most central thing” for officers who have to worry about war-fighting strategy or technology, argues Michael O'Hanlon, a defence analyst at the Brookings Institution in Washington, DC. “You can make the argument that people should be learning engineering or military history.” Moreover, he notes, the corporate style of Donald Rumsfeld, a former defence secretary who (like many top corporate leaders) thrived on risk-taking, “didn't work out so well.”

But some overlaps are clear. Naval officers dislike making tough personnel decisions, says Phil Quast, a retired vice-admiral who oversees executive education for the navy. And vice-admiral John Jay Donnelly grumbles about his e-mail overload as bitterly as the next branch manager. “Delegate”, he is advised.

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**Face value**

# Digging deep

Feb 8th 2007
From The Economist print edition

**Zanele Mavuso Mbatha wants to turn an investment company into a diversified mining giant**

Get article background

SINCE she took the reins at Incwala, a South African mining-investment firm, last September, Zanele Mavuso Mbatha has been avoiding the media. She is not keen on personal publicity. “It's not a Zanele show,” she says firmly. “It is an Incwala show.” Yet in South Africa's mining business, still dominated by white males, Ms Mavuso Mbatha cuts an unusual figure. The 36-year-old is at the helm of $1.7 billion of platinum assets, which make Incwala one of the largest black-owned and -operated companies in South Africa's mining industry.

Incwala, which means “first fruits of the season” in Zulu, started life in the limelight. Born in 2004 out of Lonmin Platinum (Lonplats), the world's third-largest platinum producer, it is a product of the country's “black economic empowerment” (BEE) policy, which is meant to redress the economic injustices inherited from apartheid. South African mining companies are expected to do their bit, which among other things means transferring 26% of their capital into black hands by 2014. When Impala Platinum decided to divest from its joint venture with Lonmin, 18% of Lonplats went to the newly created Incwala, thus helping Lonplats's parents meet their empowerment obligations. Incwala was touted as the future flagship of black mining in South Africa, and expectations ran high.

More than two years and three chief executives later, however, little has happened. A share in another platinum mine has been added to its holdings, also via Lonplats. But a planned tie-up with the mining division of Mvelaphanda, another BEE heavyweight, fell through last year. A few months later, Incwala's boss, Arne Frandsen, packed his bags. Ms Mavuso Mbatha, a shareholder of Incwala and deputy chair of the board, took the job.

The daughter of exiled political activists, she left her Soweto home as a child and was schooled in Swaziland, Zimbabwe and the Netherlands, before studying international economics in California. All this was light years away from the second-rate Bantu education provided to black South Africans under the apartheid regime. After a few years as an investment banker in New York, Ms Mavuso Mbatha moved back to South Africa in 1997, versed in mergers and acquisitions in mining. This, she says, had always been the plan: “When you're an exile baby, your final destination is South Africa.”

But after years of absence, returning home took some getting used to. “In business, a black woman was nothing,” she recalls. It was a long way from the politically correct sentiments of Wall Street. Speaking Sotho and Zulu softened the culture shock, but only slightly. In the late 1990s BEE was in full swing, but early deals involved a handful of well-connected heavy hitters. Confident that this would change, Ms Mavuso Mbatha created her own investment company, Dema, with a partner. By the time Lonplats engineered its own empowerment transaction, the mood had changed, and companies were looking for different types of partners. Dema became one of the three lead black investors, which, together with Lonplats employees, local people and a women's group, own 53% of Incwala.

Although the deal-flow may have been disappointing, Incwala has been doing well. Thanks to strong platinum prices and the quality of its investment—Lonplats is amongst the lowest-cost platinum producers in the world—Incwala's market value has climbed from $650m at its birth to $1.7 billion today. Yet it remains a start-up, albeit one with a fat balance sheet.

Ms Mavuso Mbatha has big ambitions, and her proposal for a new way forward has just got the nod from the board. The idea is to turn Incwala from an investment company into a diversified mining operator. The company is shopping for other mines, in platinum and other metals too, and will seek management control whenever possible. Ms Mavuso Mbatha expects to see some consolidation within the black mining world in the next few years, and Incwala needs more assets under its belt if it wants to acquire, rather than be acquired. “In this situation, size will matter,” she laughs. Her ambition is to turn Incwala into the BHP Billiton or Xstrata of tomorrow. Incwala is now busy raising debt to refinance existing liabilities and pay for future acquisitions. The target is for Incwala to manage at least one mine within the next two or three years. Then a listing may be on the cards.

## Panning for gold

Finding new assets should be relatively easy and several deals are in the pipeline. Mining companies are required to fulfil their empowerment responsibilities in order to keep their mining rights. Incwala helped Lonplats convert its mineral rights, the first platinum company to do so. It is also helping craft the social and community programmes required by the government. This could make Incwala an attractive partner for other mining companies with similar needs. “Everybody returns my phone calls,” smiles Incwala's boss.

But turning an investment company into a mining one will be tricky. Ms Mavuso Mbatha can do deals, but she is no miner. So far, Incwala is a one-woman show, with a total staff of five. In a country short on skills, finding the right people will not be easy. Talented black professionals are either climbing corporate ladders or chasing empowerment deals of their own. And the commodity boom means skilled workers of any colour are being pursued by foreign companies as well as local ones.

BEE has been criticised for creating dealmakers, rather than genuine entrepreneurs and much-needed jobs. This is a fair point, Ms Mavuso Mbatha admits, but things are changing, and she wants to be part of that change. Her parents' generation fought for political rights. “My generation”, she says, “will be judged over whether it helps create a sustainable economic miracle to maintain political freedom.”

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**Private equity**

# The uneasy crown

Feb 8th 2007 | DAVOS, LONDON AND NEW YORK
From The Economist print edition

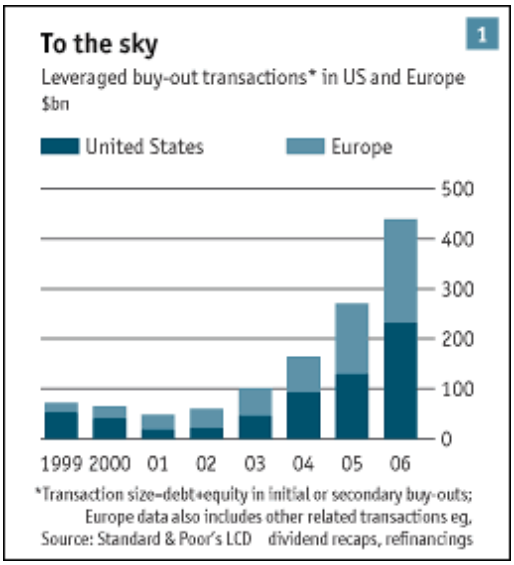
Sharon Tancredi

**The buy-out business is booming, but capitalism's new kings are attracting growing criticism**

HEROD was not the monarch this newspaper had in mind when in 2004 it proclaimed the leaders of the private-equity industry the "new kings of capitalism". It was Louis XIV perhaps—the sort of ruler whose kingdom grew rapidly in size, power and reputation, just as private-equity firms have done.

Last year the value of private-equity buy-outs, usually by taking private a company which is trading on a public stock market, surged to $440 billion in America and Europe (see chart 1). Ever bigger companies are being gobbled up. On February 7th Blackstone Group won a bidding war for Equity Office Properties (see article), setting a new high of $39 billion, including debt, for a private-equity acquisition.

Few firms seem beyond the industry's grasp. J. Sainsbury, a British supermarket chain, is among the latest targets. The grapevine buzzes with talk of others, including Dell and even IBM. Such is the fuss that some boosters extrapolate the rise of private equity even to the death of the public-listed corporation, which they argue has become obsolete.




Yet when a group of tycoons gathered in London in January for the Private Equity Foundation, a new charity for children, a trade union picketing the launch said it was "like Herod becoming a patron" of Britain's National Society for the Prevention of Cruelty to Children.

Sharp criticism has become a daily nuisance for the private-equity industry. Its leaders, such as Steve Schwarzman of the Blackstone Group, David Rubenstein of the Carlyle Group and Glenn Hutchins of Silver Lake Partners, were treated like royalty at the recent World Economic Forum in Davos. But having to debate "Is bigger better in private equity?" and then listen to Philip Jennings, general secretary of UNI Global Union, tell them they "should no longer consider themselves untouchable" took the edge off their acclaim.

They can be forgiven for a sense of déjà vu. Until recently, private equity seemed to have shed its bad-boy image of 20 years ago, summed up in "Barbarians at the Gate", a bestselling book about the battle by Kohlberg Kravis Roberts (KKR) to buy RJR Nabisco. But from barbarians to Herod in two decades hardly

seems like progress.

The 1980s boom in private-equity deals—then known as leveraged buy-outs (LBOs)—came to an abrupt and messy halt. The buy-out firms found they had over-paid for some acquisitions, credit markets dried up, some of the important providers of finance (such as Michael Milken, the “junk-bond king”) ended up in jail and regulators cracked down on their beloved hostile takeover bids.

Nobody expects to see a repeat of that reverse, even though some criticisms are eerily familiar. Unions complain that buy-out firms are asset-strippers: the London protest was against the axing of jobs by Birds Eye, a food company owned by Permira, the biggest European private-equity firm. But now fellow financiers are also on the attack. “Am I alone in struggling to make sense of private equity's appeal?” wrote Michael Gordon, the chief investment officer of Fidelity International, in a recent letter to the *Financial Times*.

Regulators, too, are growing agitated. Last year Britain's Financial Services Authority concluded after an inquiry that at least some of the industry's activities will end in tears. America's Department of Justice is investigating whether the increasingly common bidding consortia, in which several private-equity firms club together, are in breach of antitrust laws. Last month the Federal Trade Commission ordered Carlyle and Riverstone to cease day-to-day involvement in one of the two energy firms they own, so as to ensure competition. In Congress Barney Frank, the new Democratic chairman of the powerful House finance committee, is due to hold hearings on private equity.

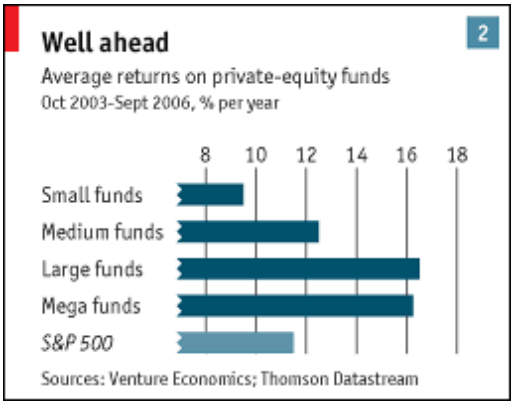
Shareholders of targeted companies are also starting to smell a rat. They suspect that top managers, who usually remain in charge when their business passes into private hands, are selling too cheaply in order to get a bigger slice of the profits for themselves when the private-equity buyer eventually sells the firm on. Recent attempts to take ClearChannel and Cablevision private met fierce opposition from shareholders feeling short-changed.

## Making their case

The kings of capitalism have started to respond. In December several top American private-equity firms formed the Private Equity Council to fight their corner in Washington, DC. Similar groups already play that role across the Atlantic.

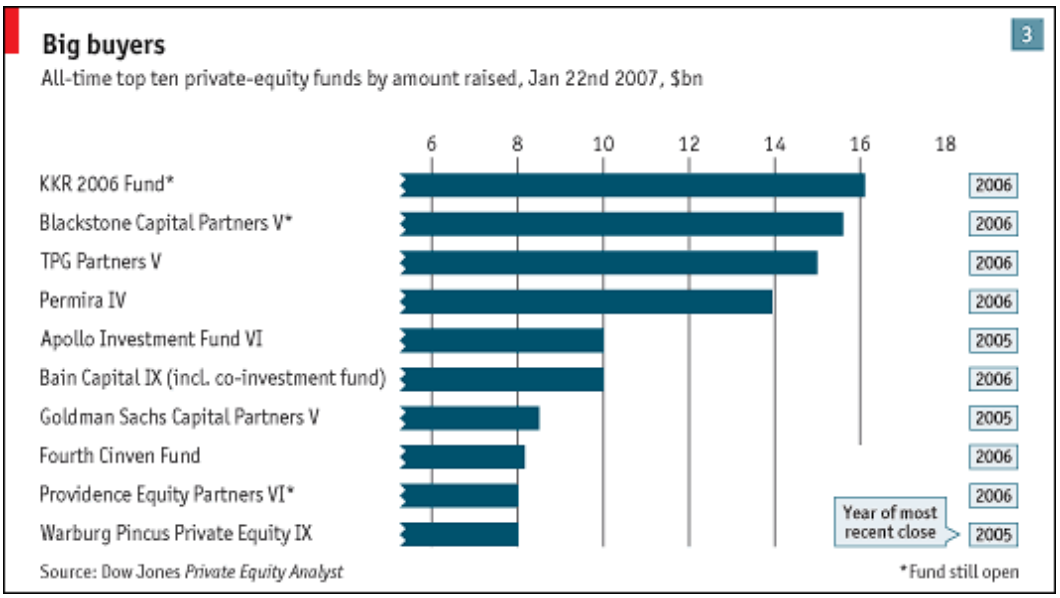
In Davos Carlyle's Mr Rubenstein conceded that the industry “does an awful job” in presenting itself to the public. Rather than talk about the jobs created for blue-collar workers, too often people in private equity “brag about how much money we make”. As a first step, the private-equity bosses agreed to sponsor a two-year research project. Mr Rubenstein expects it to show that “most of the money we make goes to public pension funds. We create a lot of jobs and pay a lot of taxes.”

The main defence offered by private-equity firms is that they are good for the companies they own and for the economy as a whole. Henry Kravis of KKR claimed last year that private-equity investing “leads not only to value creation, but also to economic and social benefits, for example, increases in employment, innovation, and research and development”.




The past three years have been extremely good for private equity with returns for all but the smallest funds comfortably beating the S&P 500 index (see chart 2). Long-term performance also looks strong, at least at first glance. From 1980 to 2001, the average fund generated higher gross returns than investing in the S&P 500, according to a study by Steve Kaplan of the University of Chicago and Antoinette Schoar of the Massachusetts Institute of Technology.

Given the obsession of investors with yield, no wonder so much money has poured into private equity. There are now some 2,700 private-equity firms, managing assets of $500 billion. They are led by a number of giants (see table 3). Only two years ago the largest fund was worth $6 billion, but some reports say Blackstone's fund is now worth some $20 billion.




However, the headline numbers come with caveats. First, they do not include the typically huge fees paid to the general partners who manage the funds. Mr Kaplan and Ms Schoar found that, on average, the returns to investors after subtracting these fees were slightly lower than they would have received by investing in the S&P 500 in 1980-2001.

Secondly, they found huge differences in performance between funds. In 1980-2001, the top quartile of private-equity funds produced an annual rate of return of 23%, well ahead of the S&P; the bottom quartile earned investors only 4%. Not only was there a large gap between the best and the rest, but their respective performances were also remarkably consistent. The study showed that the winners in private equity tend to keep on winning and the bad firms stay bad—if they remain in business. Anecdotal evidence suggests that this pattern has endured, with the notable change that big firms are now outperforming the rest and in turn attracting a disproportionate slice of new money.

What makes a top performer? Mr Kaplan lists some characteristics: the expertise to analyse deals and add value; the ability to attract the best executives and other talent to companies; and a strong network to search for deals, sometimes avoiding auctions.

Some suspect that success is all about higher levels of debt. Private-equity firms borrow heavily to buy companies—the equivalent of a gambler borrowing money to double his bet. Given that higher leverage equals higher risk, where is the benefit? As Fidelity's Mr Gordon puts it, ultimately investors in private equity are backing the same companies that they held as listed groups. “Performance over time will be driven by the same factors: earnings growth, cost management and so on,” he adds. “The difference is leverage. Strip out the leverage and the correlation with quoted equities is tight.”

There is a lot to this. In the early days leverage was responsible for most of the superior returns. Moreover, the easy credit of the past three years has helped. (An arguably worrying development has been the rise in “leveraged recaps with equity dividends”, whereby a recently acquired company borrows heavily in order to pay a large dividend to its new owner.)

On the other hand, since the mid-1990s private-equity firms have taken every opportunity to stress that they do not depend on financial engineering—a technique that they say is now widely imitated by public companies and thus no longer a source of advantage. Instead, they prefer to draw attention to other ways in which they improve the firms they own.

One is corporate governance. Unlike the owners of public companies, who tend to be too remote and thinly spread to spend time and money closely monitoring a business, private-equity firms have big stakes. Because their people's careers are on the line, they have a powerful incentive to keep a close eye on things. There is also a strong incentive to maximise long-term value—which is what stockmarket investors are valuing in an initial public offering (IPO). Asset stripping is rarely the best long-term strategy. Even when they sell—at least in an IPO—private-equity firms often retain a significant shareholding for years after.

This claim has some academic support. In a recent study, “The Performance of Reverse Leveraged Buyouts”, Jerry Cao of Boston College and Josh Lerner of Harvard Business School, examined the post-IPO

performance of nearly 500 companies floated by private-equity firms in 1980-2002. They found the shares of the firms sold outperformed both the overall stockmarket and shares issued in other IPOs that were not backed by private equity. Highly leveraged firms performed no worse than those with less debt. Bigger IPOs backed by private equity did even better than smaller ones.

But Messrs Cao and Lerner sounded a note of caution. Those firms that were owned by private equity for less than a year performed relatively poorly, suggesting that “buying and flipping” back to the market—increasingly common nowadays—is a less useful role for private equity than building improvements into the business over a few years.

## Old hands

Experience also counts for more. Private-equity firms used to be run only by financiers, but they are now adding partners (albeit not as fast as some would like) who have run big companies. These include superstars such as Jack Welch, formerly of General Electric (GE), and Lou Gerstner, once head of IBM. A huge service industry has grown up to help, providing lots of work for consultants and headhunters. Bidding consortia allow generalist firms to team up with specialists to gain expertise. Silver Lake, for instance, is much sought-after by clubs bidding for technology companies; Providence Equity Partners plays a similar role in media deals.

Firms in private-equity portfolios are free of the most onerous regulations to which public companies are subjected, such as aspects of America's Sarbanes-Oxley act, which was rushed into law after the collapse of Enron. They are subject to less scrutiny in the press, especially when it comes to short-term dips in profits. And they can pay executives whatever they wish without facing an uproar. Compared with public companies, private-equity firms tend to be more generous in rewarding good performance, but they punish failure more heavily. Given that many of the most talented executives are risk-takers who want to get rich, it is no surprise that many are switching to private equity.

The “drain of management talent at all levels to private equity is one of the main reasons I am open to taking the firm private,” the boss of a company with a market capitalisation of $16 billion recently told *The Economist*. That is the most striking difference between private equity today and in the 1980s, says Chicago's Mr Kaplan. “In the 1980s company bosses were implacably opposed to LBOs. Now they see an opportunity to be able to do a better job and be better paid when they succeed.”

Many bosses have become evangelists for private equity. Cristóbal Conde, the boss of SunGard, is quick to enthuse about how much more helpful his financial software company's new private-equity owners were than he expected, encouraging him to concentrate on long-term growth.

More threatening than criticism are the problems of success. With so much interest in private equity, more money than ever is chasing deals. To increase the number of deals they can do, several of the bigger firms are said to have become interested again in hostile takeovers, at least for the funds they are now raising. Club deals may also pose difficulties, especially if things do not go according to plan and partners have a difference of opinion.

And there are the diseconomies of scale common to any business that has grown so far from its entrepreneurial roots. Not for nothing have the biggest private-equity firms been called the “new conglomerates”. They are sprawling empires, with extremely diverse firms to manage. For example, Blackstone's portfolio includes stakes in Michael's, an arts and crafts retailer; Emcure Pharmaceuticals; Deutsche Telekom; Orangina, a drinks firm; FGIC, a bond insurer, and Houghton Mifflin, a publisher. It also owns part of SunGard in partnership with KKR. KKR's assets include HCA, a health-care firm; NXP, once the semiconductor business of Philips; Primedia, a publisher; Sealy, a mattress-maker; and Toys “R” Us.

Can private-equity firms manage their empires? Harvard's Mr Lerner worries about the spread of bureaucracy and in-fighting, including battles over how to share out the spoils when the performance of different parts of the firm varies sharply. He points to Carlyle as a good example of a firm tackling these difficulties with its centralised, team-building “One Carlyle” process. As the founders step down at several of the bigger private-equity firms, succession may add to the burden.

## When the credit stops

The credit markets show no sign of losing their appetite for lending. On the contrary, private-equity firms report turning down offers of credit because they are too generous. Nonetheless, leverage is rising steadily, to worrying levels. One day the market will dry up, perhaps suddenly, and what will happen then?

Chicago's Mr Kaplan is surprisingly optimistic. The repayment terms on loans to private equity are far more generous than in the 1980s, when repayment of the principal started immediately. Now there is often no requirement to start repaying the principal until after seven or more years. As a result, private-equity firms are likely to have a lot of time to put things right if one of their firms gets into trouble.

The industry also has to watch for a change in the behaviour of public companies, which are starting to respond to shareholder pressure to get a higher price from private-equity bidders. “Shareholders are increasingly asking why they are selling at a price less than what it will be worth in the future.” says Colin Blaydon, of the Tuck Centre for Private Equity and Entrepreneurship. GE recently imposed limits on the number of private-equity firms that could club together to bid for its plastics division to try to ensure a competitive auction rather than a carve-up.

Activist hedge funds are also putting pressure on likely targets to increase their borrowing. This, they think, will both increase the value of the firm in just the way it would under private-equity ownership, and remove one of the main incentives for private equity to buy.

Perhaps the greatest threat to the continued growth of private equity is regulation. The burden on public companies may be eased. Sarbanes-Oxley is likely to be given a makeover this year, with its notorious section 404 on internal controls watered down. On the other hand, politicians may increasingly try to regulate the private-equity industry.

One chief executive recently observed: “The moment a public pension fund loses 20% of its value due to some private-equity investment going wrong, private equity will get its own Sarbanes-Oxley.” The new kings of capitalism must try to prevent this from happening by showing that they really are a force for good.

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**Japan's currency**

# Carry on living dangerously

Feb 8th 2007
From The Economist print edition

Satoshi Kambayashi

**Speculators and low interest rates have helped cheapen the yen, putting the world economy at risk**

**Get article background**

THE yen is perhaps the world's most undervalued currency. It is even cheaper than the Chinese yuan by some measures. Last week the Japanese currency hit an all-time low against the euro and its real trade-weighted value fell to its lowest since at least 1970, according to an index tracked by JPMorgan. But do not expect the G7 finance ministers and central bankers meeting in Essen, Germany, on February 9th and 10th to spend much time discussing the yen, let alone to do anything to support it.

American and European policymakers do not see eye to eye on the yen. The Europeans would like some action to push up the currency, which, they say, is not bearing its fair share of the dollar's decline. Our latest update of *The Economist*'s Big Mac index suggests that the yen is a massive 40% undervalued against the euro. America's big carmakers have also complained that the weak yen makes imported Japanese cars unfairly cheap. However, neither the American nor the Japanese government thinks there is a problem. Hank Paulson, America's treasury secretary, says he is not worried about the yen's weakness because it is market-driven and reflects economic fundamentals—namely low interest rates and a fragile economy. China, in contrast, is accused of manipulating its currency with heavy intervention.

Mr Paulson is being short-sighted. Even if Japan is not intervening to hold down its currency, the yen is still misaligned. A country with one of the world's largest current-account surpluses and low inflation (but no longer deflation) should have a much stronger currency. Japan's economy is no longer flat on its back. Last year it grew by an estimated 2.3%, and it is forecast to maintain a similar pace this year. As a result, Japan does not need such low interest rates or a super-cheap currency any more. Indeed, Japan's abnormally low rates could be viewed as a form of intervention to hold down the yen.

The Bank of Japan (BoJ) bowed to government pressure and held rates unchanged at 0.25% in January. But figures due on February 15th, which are expected to show that GDP grew at an annual rate of 3.5-4% in the three months to December, could give the bank the green light to raise rates at its next meeting. This weekend the G7 could usefully back such a move.

The yen has been pushed down in recent months by the highly profitable “carry trade”. At its simplest this involves borrowing in yen at very low interest rates to buy higher-yielding assets, such as American or

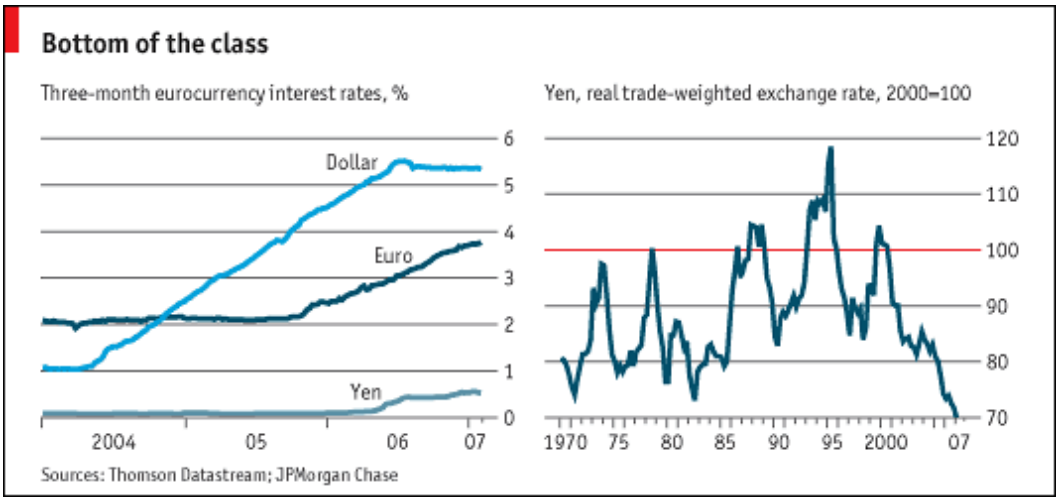
Australian bonds, or even emerging-market debt that offers a still more lucrative interest margin. Carry trades weaken the Japanese currency, because investors sell the borrowed yen to convert them into other currencies.

Carry trades make sense only if the investor assumes that the yen will remain weak. If it appreciated, this would increase the repayment cost of yen-borrowing and offset the interest differential. But such an assumption is dangerous when the yen is already so undervalued. In theory, carry trades should not yield a predictable profit because the difference in interest rates between two countries should equal the rate at which investors expect the low-interest-rate currency, here the yen, to rise against the high-interest-rate one. But the carry trade turns this logic upside down by causing the yen to fall, not rise. This, in turn, lures more investors into the same strategy, amplifying the distortion. Mr Paulson may be revealing more than he intends when he says the yen is “market-driven”: the market is chasing its own tail in defiance of the economic fundamentals.

## An elusive number

Nobody really knows how big the carry trade is. Japanese official figures show little evidence of large net lending to foreigners. For much of 2006 Japan actually had a net inflow of bond investment. Estimates based on the short-term net foreign lending of Japanese banks put the carry trade at only $200 billion.

But hedge funds do not need to borrow yen and then buy higher-yielding currencies. Instead, the carry trade is typically done through transactions, such as currency forward swaps, that are off-balance-sheet and therefore do not show up in official statistics. A better clue comes from record net “short” positions in yen futures on the Chicago Mercantile Exchange. Estimates of the total size of the carry trade range as high as $1 trillion.




The term “carry trade” usually refers to leveraged trades by speculative international investors, such as hedge funds. But Japanese households have also shifted money out of their low-interest-rate bank accounts to earn a higher return in, say, New Zealand bonds. These outflows are certainly large, but they are of a very different nature. If markets suddenly become more volatile, hedge funds can very quickly unwind their short yen positions, whereas households are more likely to sit tight. It is the volatile type of trade that central bankers lose sleep over.

The received wisdom in the markets is that yen carry trades will continue as long as the BoJ raises rates only slowly. It would take a rise in Japanese interest rates of at least two percentage points to undermine these trades, and nobody thinks that likely in the next year or so. Furthermore, goes the argument, as long as interest rates stay low, so will the yen.

In fact, the main trigger for an unwinding of carry trades is likely to be not Japanese interest rates, but an upsurge in currency volatility. That is what happened in 1998, when enormous yen carry trades had built up. After Russia's default in August and the subsequent near collapse of Long-Term Capital Management, hedge funds reduced their leveraged positions and the yen started to rise. Then in October the Japanese government announced a plan to recapitalise its crippled banks, which further bolstered the currency, forcing those who had bet against it to cover their positions. The yen jumped by 13% within three days.

Nouriel Roubini, at Roubini Global Economics, says that the lesson of 1998 is that it takes only a small piece of positive news to unravel such trades. Suppose there is suddenly some good news about the Japanese economy at the same time as America's appears to be stalling. An initial rise in the yen could cause today's carry trades to unwind just as rapidly, causing the currency to soar, American interest rates to rise and risk spreads to widen. The volume of yen-related leverage is probably greater now than in 1998.

The G7 should be concerned about carry trades not just because they could suddenly unwind and trigger financial turmoil but also because the yen's misalignment is distorting the world economy. The yen carry trade has amplified global liquidity (see article), further inflating asset-price bubbles across the world. The trade has also prolonged global imbalances by making it easier for countries such as America, Britain and Australia to finance their large current-account deficits.

A severely misaligned exchange rate calls for action. It is true, as Mr Paulson says, that Japan is not intervening to hold down the yen. But since Japan still holds almost $900 billion of foreign-exchange reserves, accumulated a few years ago when it was intervening, it is hard to claim that the currency is truly market-determined. Stephen Jen, an economist at Morgan Stanley, argues that Japan's Ministry of Finance should consider selling some of those reserves to break the one-way bet against the yen. There is a risk that such a move could itself upset financial markets. But the lower the yen slides, the greater the threat of an even sharper rebound.

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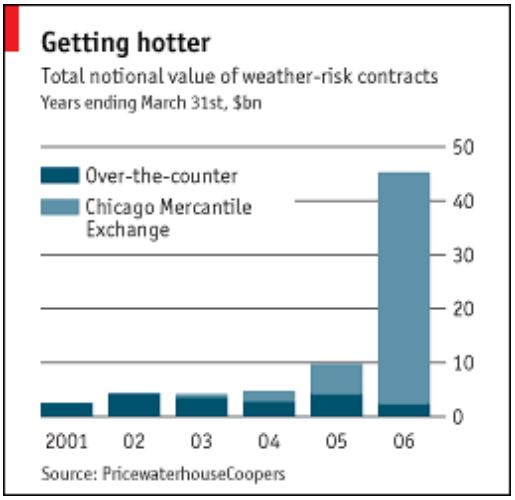
**Weather risk**

# Come rain or come shine

Feb 8th 2007
From The Economist print edition

### Hedge funds find a new way to profit by taking on the weather gods




WEATHER has toyed with mankind ever since the first caveman blinked into the baking sun. Some of his descendants eventually became insurance underwriters, offering to ease the sting of droughts and storms for a fee. But only recently has the species worked out how to turn nature—with all its vagaries—into a tradable asset in its own right.

As the world's weather grows more volatile (see article), interest in trading it is likely to grow, too. Hedge funds, in particular, favour three sorts of instruments linked to the changeable climate: weather derivatives, catastrophe bonds and sidecars. All are welcome innovations in risk management as insurance and banking increasingly overlap. And all are in growing demand (see chart).

Weather derivatives are normally used to hedge against unexpected swings in climatic conditions. On exchanges, they focus on widely followed measures such as temperature and rainfall in designated cities. Bilateral deals crafted off-exchange can be more creative, perhaps involving variations in the height of waves or the humidity in certain places.

The most common users are energy companies (or hedge funds trading energy risk), which account for 46% of the market. Many of them are hedging natural-gas prices that are very sensitive to warm or cold weather. Agriculture accounts for 12% of the derivatives market. This share could be bigger, but free government crop insurance in many countries has dampened demand. Aid agencies have also used weather derivatives to help poor countries cope with drought.

Catastrophe bonds, meanwhile, allow the insurance industry to spread the risks from extreme natural disasters (hurricanes, earthquakes and such) to capital markets. A popular form of insurance-linked security, cat bonds allow insurers or reinsurers to lay off narrowly defined risks onto secondary markets should the defined event hit a certain loss level. Investors, typically hedge funds, buy high-coupon bonds that are often divided into tranches. If no catastrophes occur over the designated loss level during the life of the bond, investors get back their principal and a premium. But they can also get burnt. Cat bond issuance was about $2.1 billion in 2005 (a year of big hurricanes), up 75% on the year before, and issuance rose again in 2006, says Erwann Michel-Kerjan of the Wharton School.

So far, mainstream investors, such as pension funds, have held back from the weather. But that has not stopped banks from trying to attract them. ABN AMRO, a Dutch bank, recently brought aspects of structured credit to the catastrophe market. It bundled together nine different types of swaps—on American hurricanes, European windstorms, Japanese earthquakes and such—and sold tranches to investors (including banks and insurance firms).

Sidecars are the third type of alternative weather-risk tool being used more frequently by hedge funds. Like cat bonds, they are complex instruments, offering reinsurance by issuing debt to investors. But sidecars typically involve a bigger investment (at least $200m) than cat bonds and are shorter term: they mostly self-liquidate or renew in two years or less, says Mr Michel-Kerjan. He reckons that hedge funds put more than $3 billion into sidecars in North America alone between November 2005 and July 2006.

It is not just weather that moves the market; people can too. Last month, the disaster-prone state of Florida expanded its hurricane-catastrophe fund, in effect removing $4 billion from the private reinsurance

market. Bermuda, where many reinsurers are based, was especially hard-hit. A likely knock-on effect will be a redeployment of catastrophe cover elsewhere, probably driving prices lower for a time. Just like nature, weather risk moves in cycles too.

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**Buttonwood**

# Mutiny in the ranks

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**Reasons not to savour that fat bonus cheque**

“IT'S the rich wot gets the pleasure, it's the poor wot gets the blame.” The soldiers who sang that ditty in the first world war may have been reflecting on the contrast between their lice-ridden, shell-shocked existence and the creature comforts available to aristocrats back home.

There was an enormous disparity between the income and wealth of the top and bottom classes of society in the early days of the 20th century, as there is today, another era of boisterous global trade. The issue of inequality prompted Ben Bernanke, the Federal Reserve chairman, to make a speech on February 6th calling for improvements in education and training to help displaced workers.

Ajay Kapur and Niall Macleod, two Citigroup strategists, have invented the term “plutonomy” to describe an economy where the spending power of the elite holds sway. They argue that American savings data are distorted by the top 20% of the population. Whereas many Americans are reasonably thrifty, the wealthiest group spends more than it earns.

The rich need not save because financial markets are doing their savings for them. Rising equity and house prices drove up the net-worth-to-income ratio of the wealthiest tenth of Americans from 5.8 in 1989 to 8.4 in 2004. That gives them a licence to spend and makes them immune to petty worries like higher petrol prices.

Furthermore, Messrs Kapur and Macleod say the rise of wealthy elites in Russia and Asia may help explain why America finds it so easy to fund its current-account deficit. Emerging-market plutocrats are nervous about keeping their fortunes at home, lest the political winds change. So they seek to move as much of it as possible to richer countries. This, together with reserve management by the central banks in Asia and oil-exporting countries, provides a steady source of demand for American assets.

But what has caused this great dispersion of wealth? It is not happening in all countries. The gap has been widening in America, Britain and Canada but has barely budged in France, Japan or the Netherlands. The two strategists cite numerous factors, including rising executive pay and technological innovation, which have rewarded high-skilled individuals. Globalisation, which seems to have lowered the relative cost of unskilled labour and boosted the return to capital, has also played its part.

Actually, if one looks at a broad sweep of history, it is the relatively egalitarian 20th century that seems the exception. Mass democracy is only 100 years old and it ushered in both the welfare state and redistributive taxation. The rise of democracy, in turn, was driven by the economic power of workers, especially those gathered in large groups to work in mining, manufacturing and transport. As those industries have ebbed, so have the forces of economic equality.

But although the workers have lost some of their economic power, they have not lost their votes and may yet use them to redress the balance. Messrs Kapur and Macleod suggest there may even be a link between the growth of profits as a proportion of national income and the rising popularity of far-right European parties such as the National Front in France.

If there were such a backlash, it could be a threat not just to globalisation, but to democracy itself. Opinion polls and low voter turnout at elections may indicate widespread public disillusionment with politicians. There is also scepticism about the fairness of the political process, given the role companies play in financing political parties. And this is during strong economic growth: imagine what a recession could do.

The prospects for a tax grab on company earnings are limited, given the ability of corporations to move quickly across national boundaries. But even in countries (like America) without extremist parties on the left or the right, politicians will be tempted to deflect the voters' wrath away from their corporate paymasters and towards an easier target—“foreigners” of all types. Hence the potential appeal of protectionist and anti-immigrant policies.

In time, this could undermine globalisation and reverse the relative advantages of the rich (and the higher trend in profits). Although many might welcome a more egalitarian world, the risk is that protectionism would usher in a deep global recession, as it did in the 1930s.

It is easy to assume, with globalisation, that a rising tide lifts all boats. And most people do gain, even if the improvement in their way of life can sometimes be hard to discern. But workers whose factories are shut are unlikely to see it that way. For them, it must seem these days that a rising tide lifts only all yachts.

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American property

# Quite a performance

Feb 8th 2007 | NEW YORK
From The Economist print edition

**Blackstone wins the battle for EOP, but the clear victor is the seller**

WHERE better to play out the final act of a hugely entertaining real-estate drama than Chicago's Civic Opera Building? That is where shareholders gathered on February 7th to decide the fate of Equity Office Properties (EOP), America's largest commercial landlord. They had an enviable choice to make. They could take a handsome cash offer from The Blackstone Group, a private-equity giant that valued the company at nearly $39 billion (including debt), far more than anyone had thought it could fetch a few months ago. Or they could go with a bid that was slightly higher but a riskier mix of cash and shares, from a group led by Vornado Realty Trust, another listed property company. A couple of hours before the vote, Vornado capitulated, leaving Blackstone the winner. The shareholders in Chicago, however, had the most to celebrate.

It was a humdinger of a battle. Sam Zell, EOP's founder, had talked to Vornado about a possible tie-up last summer. In November, however, after those negotiations faltered, Mr Zell agreed to sell to Blackstone for $48.50 a share, almost $20 more than the stock had been worth only months earlier. Shrewdly, he insisted on keeping a low “break-up fee”—payable to Blackstone if it lost out to another suitor. This made it easier for other bidders to come in. Vornado and its partners swooped in mid-January, forcing the private-equity firm to raise its offer twice, to $55.50 a share. That makes the deal the biggest buy-out ever in nominal terms, eclipsing the takeover of HCA last year, as well as the biggest acquisition of a real-estate investment trust (REIT). No wonder Mr Zell has earned the nickname “Gravedancer”.

Mr Zell has not always been so clever: he overpaid for a cluster of Silicon Valley buildings during the dotcom crash, for instance. But this time he did himself proud, squeezing nearly $3 billion more out of Blackstone than it had originally put on the table.

With queues forming to congratulate the canny 65-year-old, Blackstone's victory might look a touch hollow. In its favour, America's commercial-property market continues to boom, even as residential prices stagnate or fall. The main REIT index—which counts EOP as a member—shot up by 34.4% last year. The office market went up by even more. Pension funds, keen to diversify out of shares and bonds, have been raising their allocations to property.

Moreover, Blackstone knows the game, having amassed a large property portfolio—including Trizec Properties, bought jointly with Brookfield last October for $4.8 billion. With interest rates low, it can borrow cheaply against the value of EOP's assets and use the cashflow from rents—which are high and rising in most big cities—to cover its interest payments. Its plan may be to carve out and sell separately some of the firm's trophy properties in New York, Seattle and Los Angeles. One reason EOP fell prey in the first place was that its shares were trading at less than the estimated value of its assets.

But Blackstone's buy-out barons would struggle to make the deal pay if offices were to go the same way as housing. The REIT index jumped another 8% in January alone, leading some to wonder about the boom's sustainability. “I thought we'd reached the peak 18 months ago, but it continues to defy expectations,” says the boss of one conglomerate's property arm.

Vornado's chief executive, Steven Roth—like Mr Zell, something of a legend in the world of steel and concrete—will no doubt be feeling sore. He told shareholders last year that, with the office market soaring, “every single deal we didn't do [in recent years] was a mistake,” the *Wall Street Journal* reports. On this occasion he may, given time, have fewer regrets.

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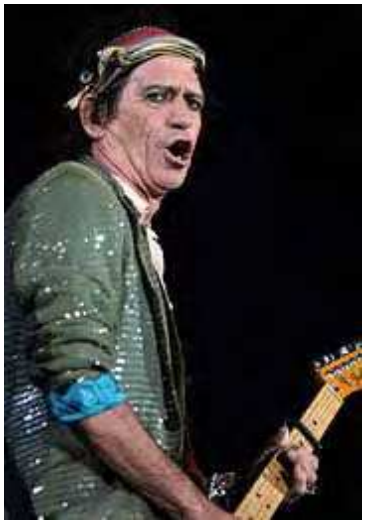
**Pensions for musicians**

# When they're 64

Feb 8th 2007 | AUSTIN
From The Economist print edition

**What do musicians do when they rock towards retirement?**

AFP



**Longevity risk**

AUSTIN, the capital of Texas, proclaims itself the “Live Music Capital of the World”. Bands blast cowboy and blues songs each evening along Sixth Street, the town's answer to Bourbon Street in New Orleans. As morning dawns, musicians stumble home to financial drear. Many live below the poverty line. Few have health insurance. Some still hope they will die before they get old. For the rest, pensions are mostly a dream.

One Texan band is aiming for change. Robert Earl Keen, whose eponymous country band played at George Bush's inauguration, decided it was time to “run a business just by having good manners”. Some years ago he created a pension plan for the self-employed, known as a SEP-IRA, for his band members, and began to pay into it. His latest addition is a health-care plan. These have helped keep his band together.

Such munificence is rare in the music world, where business is unsteady for most travelling bands. Plenty of drummers and singers live from gig to gig. More musicians have insurance for their instruments than they do for their health, notes Jude Folkman of the Music Resource Group, which helps independent musicians. Some get insurance through day jobs or spouses, but many go without. Even independent record labels or booking agents struggle to provide insurance for their employees.

Unions help a bit. The American Federation of Musicians offers health insurance for members, but few travelling musicians take it up. As for pensions, “it's tough for a band or band leader to put a pension plan together,” says Tom Lee, president of the American Federation of Musicians. The union offers a multi-employer set-up, into which labels are supposed to pay a percentage of artists' wages, but things are still tough. Often, according to Mr Keen, musicians “get gypped at all kinds of levels”—not getting paid in full for their performance, or playing too long without overtime. The minimum wage bill just passed by Congress will be of little help. But recently, the state of New York approved a law that redirects the food and beverage tax at jazz clubs into musicians' pension funds.

Of course, there are always benefit concerts for the truly destitute. And with musicians like Chuck Berry and BB King rocking into their 80s, retirement for some seems a notional concept.

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China's stockmarket

# Hot and cold

Feb 8th 2007 | HONG KONG
From The Economist print edition

**Nervous officials talk down the market after its scorching run**

AP

Shanghai surprise

JUST when it looked as if prices of domestically traded shares in China were approaching lunatic levels, a reassuring thing happened: the stockmarket cooled down. After more than doubling in 2006 and setting new highs in January, the Shanghai and Shenzhen markets fell for five straight days after January 30th, losing 11% and 8% respectively before bouncing back a bit on February 6th.

The cold shower came after warnings from Chinese officials, and some regulatory pressure. Banks were put on notice to restrict credit, following reports that people were taking out loans—and even re-mortgaging their homes—to buy shares. State enterprises were told to restrict their share purchases. Approvals for the listing of new mutual funds were briefly slowed or suspended. And rumours circulated that some fund managers might be fingered for insider trading and that the dealing records of their families would have to be scrutinised.

Most striking of all, Cheng Siwei, vice chairman of the National People's Congress, the country's highest legislative body, said 70% of the domestically traded companies were worthless and should be delisted. “We must”, he said, “force bad children out.” He faulted investors swept up in the bull market. “Some people's brains are obviously starting to get hot.”

The concern is justified. Each of the 38 companies listed on both the mainland and in Hong Kong has domestic A-shares trading at a premium. This includes the large banks such as ICBC (8%) and Bank of China (17.5%), which are avidly followed abroad and have non-Chinese share prices set in large liquid markets.

Since China's stockmarkets began operating in the early 1990s, there have been several euphoric periods, each ending in disaster. Mr Siwei's comments were widely interpreted as reflecting concern across the upper reaches of China's government about another potential bust.

But they also sent a subtler message, that it is permissible to criticise the market, says James Cheng, manager of Morgan Stanley's A-share closed-end China Fund. He notes the sharp contrast with four years ago when critics of a previous bull market faced harsh rebukes and even death threats. It is, he believes, a good sign that the Chinese government understands that a high market is not necessarily a healthy one, nor, for that matter, is it inevitably a sign of a sound economy.

There are grounds for believing this was a correction, not the prelude to a crash. Chinese companies continue to generate impressive returns. Corporate profits should be up more than 20% this year, reckons Jing Ulrich, of JPMorgan. Also, the pipeline for new listings remains packed. On February 5th China's Industrial Bank went public in Shanghai and its shares closed up 39%.

The market for bankers who can bring in new offerings is even hotter. Merrill Lynch generated much publicity with news that it had hired Margaret Ren, an astute and politically connected banker who had been forced out by Citigroup in 2004 after a probe by America's Security and Exchange Commission that was dropped last autumn. Citigroup has not recovered as well as Ms Ren. Since the incident, the bank has been an also-ran in the new-issue market, costing it a fortune.

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**Cash-handling in Germany**

# We were Heros

Feb 8th 2007 | HILDESHEIM
From The Economist print edition

**An armoured-car scam raises questions about business ethics**

THE four accused sit soberly in a Hildesheim courtroom as details emerge of more than a decade of high-living: a €250m ($300m) spending spree with money supposedly safely on its way in armoured trucks from shops and bank branches to customers' bank accounts.

The case interests not just the tabloid press. Insurers and company lawyers are arguing about up to what point the money was insured. Cash-transport insurance contracts have been written differently since. There has also been a rethink of how to supervise the whole cash-transport industry.

Germany has by far the biggest number of independent cash-transport firms in Europe and they have an impressive safety record, suffering only 12 raids in 2005; that compares with over 100 in France, and more than 700 in Britain, according to the federation of German cash transporters. But internal fraud is another matter. The case in Hildesheim is the biggest of several being pursued by prosecutors.

Karl-Heinz Weis and his three co-defendants ran Heros which, until its bankruptcy a year ago, was the biggest cash-transport firm in Germany, with 50% of the market. At its zenith it had 4,600 employees and 1,500 trucks ferrying €500m a day across the country.

By his own admission, Mr Weis, the founder and chief executive, began pilfering client money in the 1990s to fill gaps and shortfalls in the daily delivery of cash. He could use this “float” because of the delay between collecting cash, booking it into a pooled account at the Bundesbank and then transferring it to the customer's account. All sorts of excuses were invented to explain the extended “delays” as they got more frequent, such as computer failures and truck breakdowns.

Mr Weis and a few colleagues were able to finance a life of expensive cars, foreign travel, gambling—and, occasionally, philanthropy. But in December 2005 a big retail customer, Lidl, cancelled its account. So did several others, making it difficult for the fraudsters to keep things going.

In February 2006 the game was up. In a final “Robin Hood” gesture Mr Weis and his chums seized around €50m of banknotes destined to fill cash machines and credited them to Heros's smaller clients, judging that banks could better bear the loss. Such actions suggest they could not quite see what they were doing wrong. The trial is complicated by suspicions that individuals working for some of its customers, and perhaps even for its insurers, were accessories to the fraud as well. If that turns out to be so, not only Heros executives will be in the dock. Broader business ethics in Germany will be, too.

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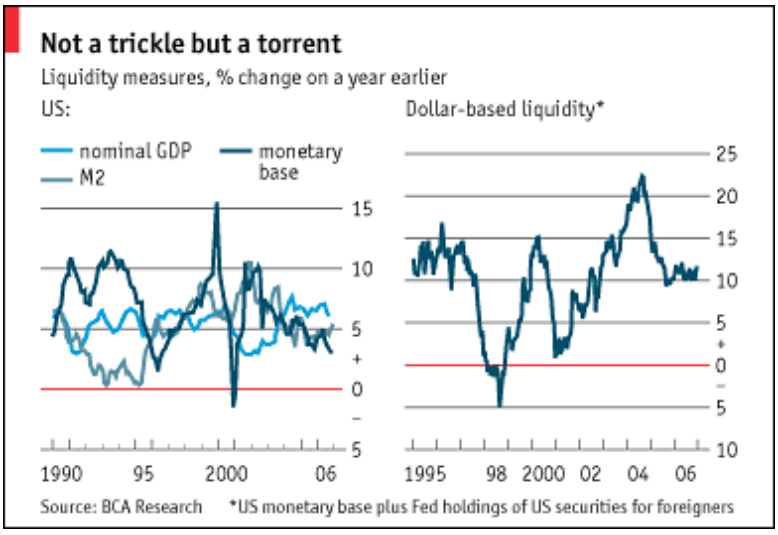
Economics focus

# A fluid concept

Feb 8th 2007
From The Economist print edition




**Just about everyone agrees that there's a lot of liquidity about—whatever it is**

LIQUIDITY is everywhere. Depending on what you read, you may learn that the world's financial markets are awash with it, that there is a glut of it or even that there is a wall of it. But what exactly is it? Again depending on what you read, you may be told that “it is one of the most mentioned, but least understood, concepts in the financial market debate today” or that “there is rarely much clarity about what ‘buoyant liquidity’ actually means.” An economics textbook may bring you clarity—or confusion. It is likely to define liquidity as the ease with which assets can be converted into money. Fine: but that is scarcely the stuff of dramatic metaphors. Liquidity thus defined is surely to be welcomed; floods, gluts and walls of water surely not.

Helpfully, Martin Barnes, of BCA Research, an economic research firm, has laid out three ways of looking at liquidity. The first has to do with overall monetary conditions: money supply, official interest rates and the price of credit. The second is the state of balance sheets—the share of money, or things that can be exchanged for it in a hurry, in the assets of firms, households and financial institutions. The third, financial-market liquidity, is close to the textbook definition: the ability to buy and sell securities without triggering big changes in prices.

## Bath time

When people worry about a glut of liquidity, they are thinking of the first of these concepts. If money is too abundant or too cheap, inflationary pressures may build up or bubbles may appear in financial markets—until central banks tighten policy or market opinion suddenly changes. A slackening of economic activity or a drop in asset prices can leave households, businesses and financial institutions in trouble if their balance sheets are not liquid enough (the second concept) or if they cannot find a buyer for assets (the third).

In principle, you can view the first concept through prices or quantities. Stephen Roach, of Morgan Stanley, suggests that for emerging markets, quantities (monetary aggregates, volumes of credit and foreign-exchange reserves) matter more; price signals (interest rates, credit spreads and so forth) are a better guide in developed economies, where capital markets are deeper and more liquid. In practice, it is usual to look at quantities.

Often, says Mr Barnes, it is assumed that the monetary environment is determined by central banks. But he thinks this too simplistic. Of course, by setting short-term interest rates they affect banks' reserves and lending, and the willingness of consumers and firms to spend or invest. They can still squeeze liquidity out of the economy, as the Federal Reserve did in the early 1980s, or create a deluge, as it did earlier in this decade. But America's bank reserves, at $47 billion, amount to only 6% of the country's monetary base and only 0.7% of the broad M2 measure of money supply. And the growth rates of both the monetary base and M2 have slowed in recent years, to below that of nominal GDP (see left-hand chart, above). From this, you might conclude that liquidity in America was not especially abundant.

However, that would be to ignore several important developments. A huge amount of credit is created outside banks and through clever instruments. Banks are increasingly able to securitise loans and get them off their balance sheets. The ratio of financial-sector to non-financial-sector debt, reckons Mr Barnes, has climbed from around 10% to 50% in the past 30 years. Financial innovation and deregulation have both helped these trends and aided international flows of credit. Looking at domestic numbers is no longer enough: you need to see the global picture.

Globally, money looks plentiful. In the euro area and Britain, broad money growth is running well ahead of nominal GDP. Or take the global supply of dollars, fuelled by America's large current-account deficit, the accumulation of reserves by foreign governments and their recycling back to the United States. A common measure of this, says Mr Barnes, is the American monetary base plus United States securities held by the Fed for foreign countries. Its annual growth rate peaked in 2004, at more than 20%. But because those securities have continued to pile up, this measure of liquidity is still growing at a rate of around 10% (see right-hand chart, above). Another gauge, combining all foreign-exchange reserves with America's monetary base, has risen at an average rate of perhaps 18% in the past four years. And this omits the contribution to global liquidity of the Bank of Japan, whose low interest rates are fuelling the “carry trade”.

All this is reflected in financial markets for everything from developing-country debt to corporate junk, commodities and art. Global willingness to save and lend is running ahead of investment. Ben Bernanke, chairman of the Fed, has spoken of a savings glut. Then again, the real puzzle could be companies' “investment restraint”, according to Raghuram Rajan, of the University of Chicago's business school (and until recently chief economist at the IMF). Maybe, he suggests, investment is becoming more centred on people and less on physical capital; maybe physical investment is being switched to emerging economies; maybe uncertainty still holds back investment abroad—as it does not, say, investment in property at home. Whatever the cause, a shortage of investment in fixed assets implies a shortage of debt collateralised on them. The financing glut has thus spilled over into markets for existing assets.

So what are central banks to do? Mr Rajan does not think that easy financing conditions can be laid mainly at their door. Still, he thinks that they may face an awkward dilemma. Tighter policy may push down long-term interest rates, boosting some asset markets further. Easier policy, however, would let inflationary pressures build. Mr Barnes concludes that it is too early to worry about liquidity: with inflation low, there is little prospect of a monetary squeeze; and American households and businesses' balance sheets (but not those of pension funds and mutual funds) are fairly liquid. Were there a market scare, he thinks, central banks would ease policy. One day, they may be tested.

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Biotechnology

# Roses are blue, violets are red

Feb 8th 2007
From The Economist print edition

**If you don't like GM food, try flowers instead**

Alamy

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BEAUTIFUL flowers—like beautiful women—can separate the most sensible of men from their money. Those men invest in the reproductive organs of plants such as roses to signal, albeit coyly, analogous intentions of their own.

The result is a cut-flower industry in which roses alone are worth $10 billion a year. But that is peanuts compared with what happened in the past. In 17th century Holland, tulips (the fashionable flower *du jour*) grew so expensive that people exchanged them for houses. One bulb of the most sought-after variety, the flaming red-striped Semper Augustus, sold for twice the yearly income of a rich merchant.

For modern flower growers, the equivalent of the Semper Augustus is the blue rose, which horticulturalists have longed for since the Victorian period. Any blue rose sent on St Valentine's day this year will have been dyed. But if Yoshi Tanaka, a researcher at Suntory, a Japanese drinks company, has his way, that will soon change. Dr Tanaka is currently overseeing the first field trials of a blue rose developed by Suntory's subsidiary, Florigene. If the trials are successful, a dozen blue roses—even if they do look slightly mauve—could, by 2010, be what separates an unsuccessful suitor from Prince Charming.

Flaming tulips. Blue roses. What Dutch growers of old and Dr Tanaka's employers both grasped is that rarity, and hence economic value, can be created by genetic manipulation.

The stripes of the Semper Augustus were caused by the genes of a virus. Not knowing that an infection was involved, the Dutch growers were puzzled why the Semper Augustus would not breed true. The genetics of blue roses, too, have turned out to be more complicated than expected. The relevant genes cannot easily be pasted into rose DNA because the metabolic pathway for creating blue pigment in a rose consists of more chemical steps than it does in other types of flower. (Florigene has sold bluish genetically modified carnations since 1998.) Success, then, has been a matter of pinning down the genes that allow those extra steps to happen, and then transplanting them to their new host.

## Buy any other name

Mere colour, however, is for unsophisticated lovers. A truly harmonious Valentine gift should smell beautiful as well. Sadly, commercial varieties of cut rose lack fragrance. This is because there is a trade-

off between the energy that plants spend on making the complex, volatile chemicals that attract women and insects alike, and that available for making and maintaining pretty-coloured petals. So, by artificially selecting big, long-lasting flowers, breeders have all but erased another desirable characteristic.

Smell is tougher to implant than colour because it not only matters whether a plant can make odoriferous chemicals, it also matters what it does with them. This was made plain by the first experiment designed to fix the problem. In 2001 Joost Lücker, then a researcher at Plant Research International in Wageningen, in the Netherlands, added genes for a new scent into petunias. Chemical analysis showed that the new scent was, indeed, being made, but unfortunately the flowers did not smell any different. As happens in Florigene's blue carnations and roses, Dr Lücker's petunias dumped the foreign chemical they were being forced to create into cellular waste buckets known as vacuoles. Whereas pigments are able to alter a petal's colour even when they are inside a vacuole, because the cell contents surrounding the vacuole are transparent, smelly molecules must find a route to the sniffer's nose by getting out of the cell and evaporating.

Like Dr Lücker, Natalia Dudareva, of Purdue University, in Indiana, eschews experiments with roses, since these plants have scents composed of 300 to 400 different molecules. She prefers to understand basic odour science using petunias and snap-dragons, which have about ten smelly chemicals apiece. She has made an encouraging discovery. By studying the many different pathways through which flowers make their fragrances, she has found consistent patterns in the way these pathways are regulated.

Such co-ordinated patterns suggest that a type of protein called a transcription factor is involved. Transcription factors switch genes on and off in groups. If Dr Dudareva is right, cut roses have lost their fragrances not because the genes that encode their hundreds of scent molecules have each lost their function, but because the plants no longer make a few transcription factors needed to turn the whole system on.

This suggests that the task of replacing lost fragrance is more manageable than it seemed at first blush. But even when the transcription factors in question have been identified, the problem of the energetic trade-off with pigment production and longevity will remain. So Dr Dudareva is also measuring how quickly the enzymes in scent-production pathways work, in order to identify bottlenecks and thus places where her metabolic-engineering efforts would best be concentrated.

Dr Dudareva's methods may also help to improve the job that flower-scents originally evolved to do—attracting insects that will carry pollen from flower to flower. By modifying the smell of crops such as vanilla, which have specific pollinator species, different insects might be attracted. That could expand the range in which such crops could be grown and thus make some poor farmers richer. A change, then, from making rich but romantic men poorer.

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**Children's medicine**

# The ideal versus the best

Feb 8th 2007
From The Economist print edition

**A programme to make drugs safer for children is up for renewal**

A SPOONFUL of sugar helps the medicine go down. That is the philosophy behind America's Paediatric Exclusivity Programme. Youngsters often metabolise medicines in a different way from adults and sometimes experience unpredictable side-effects, but the children's drug market is not always big enough in its own right for firms to bother with trials needed to find out the details of such differences. The bribe that the ten-year-old programme offers in order to shift that balance is a six-month patent extension on any product tested in appropriate child-focused trials.

It seems to have worked. More than 300 studies have been carried out under the programme's auspices, and 115 products have had their instructions for use changed so that doctors can prescribe them to children with reasonable confidence. Nevertheless, the scheme, which is up for renewal, and will be debated in Congress next month, is being questioned. Some observers think it is too generous, and that the patent extension should be shortened or tailored in some way.

A paper just published in the *Journal of the American Medical Association* by Jennifer Li, of Duke University in North Carolina, and her colleagues suggests the critics have a point. However, it concludes that tinkering may undermine the purpose of the scheme—better health for children.

Dr Li's team looked at one drug that had been granted paediatric privileges in each of nine categories (cancer, cardiovascular disease, psychiatry and so on). The team was interested in the cost of conducting the tests deemed necessary by America's Food and Drug Administration for a drug to qualify for special treatment, and the benefits that accrued from the patent-extension. The costs were estimated by Fast Track Systems and Covance Central Laboratory Services, two firms that conduct such trials under contract. Sales data were obtained from a third firm, IMS Health, which collates information on drug sales from around the country.

In the cases of eight of the nine drugs, the researchers concluded that there was, indeed, a benefit to the company (in the ninth the cost of the trials seems to have exceeded the value of the patent extension). In a similar number of cases there was also a benefit to young patients (in other words the “labelling information” describing prescription and side-effects was changed to account for their needs), though the team made no effort to quantify that benefit. The researchers did, however, quantify the benefit to the firms—and they found an enormous range. In the most lucrative case the value of extra protected sales was about 74 times the cost of the trials, and it was more than 20 times costs in three other cases.

On the face of things, that does argue for less generous terms—a three-month extension, perhaps, or some sort of differential period depending on projected earnings. On the other hand, that would complicate a scheme that, whatever its perceived vices, is both clear and effective. In an era where fewer blockbusters seem to be hitting pharmacies' shelves, that might, in turn, lead to fewer tests. Faced with the same dilemma (though not informed by Dr Li's research) the European Union decided last month to introduce a scheme similar to the one being questioned in America. It would be ironic if America now chose to change its.

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Economics and anthropology

# Patient capital

Feb 8th 2007
From The Economist print edition

**Your parents were right. Patience is a virtue**

IN MODERN economies, inequality is a fact of life. But disparities of income are a relatively recent phenomenon. For most of the species's existence, humans lived in small foraging bands that had little material surplus and therefore enjoyed a relatively egalitarian existence. The invention of agriculture, which generates a surplus that can be stored and also gives value to land, permitted this to change. But permission is not prescription. Exactly why some people were able to accumulate more than others has been something of an anthropological mystery. The archaeological record is little help, but the main hypotheses have been luck, intelligence and aggression. These all, of course, play their part, but now a fourth phenomenon has been added to the list: patience.

Writing in *Evolution and Human Behaviour* Victoria Reyes-Garcia, of the Autonomous University of Barcelona, and her colleagues describe a study they carried out on the Tsimane', a group of Amerindians who live in Bolivia's slice of the Amazonian rainforest. Until recently, the Tsimane' were almost entirely cut off from the rest of Bolivian society. They were not quite hunter-gatherers—besides hunting and foraging, they also practised slash-and-burn agriculture—but they did live in self-sufficient villages, and there was little disparity of income between villagers.

In the 1970s missionaries started running elementary schools in Tsimane' villages, and the best students have had the chance to continue their education in a nearby town. Those who do well can find jobs as village teachers, or work for government or development organisations. Even those who manage only a few years' schooling are better placed than their confrères to work for cattle ranchers and logging companies. As a result, income inequality in Tsimane' society is as high as that in Britain (although overall wealth is obviously much lower). Dr Reyes-Garcia wanted to find out what determines who wins and who loses.

One phenomenon that is almost unique to humans is deferred gratification—in other words, patient anticipation of a reward. Dr Reyes-Garcia and her colleagues therefore guessed that as the Tsimane' became more enmeshed in modern society, the more patient of them would do better than the less. The Tsimane's traditional subsistence economy depends on folk knowledge and learned skills that have quick pay-offs. Formal schooling does not pay off for years, but opens the door to bigger potential incomes.

To test their idea, the researchers offered all 151 adults in two Tsimane' villages a choice between receiving a small amount of money or food immediately, getting a larger amount if they were willing to wait a week, and getting a larger amount still in exchange for several months' wait for payment. They found that the more education a villager had, the longer he was willing to delay gratification in return for a bigger reward.

Five years later, Dr Reyes-Garcia and her colleagues came back again. They re-interviewed 100 of their volunteers (the other 51 were unavailable for one reason or another) and found that those who had shown most patience in the original experiment had also seen their incomes increase more than those of their less patient counterparts. The effect was relatively small—the incomes of the patient had grown 1% a year faster than those of the impatient. Over a lifetime, though, that adds up to a significant amount of inequality. The patient, then, could take their place alongside the lucky, the smart and the violent at the top of society's heap.

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Climate change

# Heating up

Feb 8th 2007
From The Economist print edition

**A gloomy UN-backed report is published**

THE fourth assessment report of the Intergovernmental Panel on Climate Change (IPCC), published in Paris on February 2nd, is important, unsurprising and will probably be uncontroversial. It is important because the IPCC is the body set up under the auspices of the United Nations so that governments should have an agreed-on view of the science on which to base policy. It is unsurprising because, although some of the figures differ from those in the third assessment report published in 2001, the changes are minimal and its broad conclusion, that something serious is happening and man is in part responsible, remains the same (though the authors now say that man is "very likely" to be responsible, rather than just "likely"). It will probably be uncontroversial because the few remaining climate-change sceptics prepared to speak out against the consensus argue not so much about the climate science as about its consequences. Those arguments will take place mostly around the IPCC's two follow-up reports, to be published later this year, on the impact of climate change and on what to do about it.

Part of the report's job is to consider studies of the speed of change so far. Warming seems to be accelerating somewhat. Eleven out of the dozen years from 1995-2006 were among the 12 hottest years since 1850, when temperatures were first widely recorded. So the estimate for the average increase in global temperature for the past century, which the third assessment report put at 0.6°C, has now risen to 0.74°C.

AFP

**Global warming's footprints**

The sea level, which rose on average by 1.8mm a year from 1961 to 2003, went up by an average of 3.1mm a year between 1993 and 2003. The numbers are still small, but the shape of the curve is worrying. And because the deadline for scientific papers to be included in the IPCC's report was some time ago, its deliberations have excluded some alarming recent studies on the acceleration of glacier-melting in Greenland.

Some trends now seem clear. North and South America and northern Europe are getting wetter; the Mediterranean and southern Africa drier. Westerly winds have strengthened since the 1960s. Droughts have grown more intense and longer since the 1970s. Heavy rainfall, and thus flooding, has increased. Arctic summertime sea ice is decreasing by just over 7% a decade.

In some areas where change might be expected, however, nothing much seems to be happening. Antarctic sea ice, for instance, does not seem to be shrinking, probably because increased melting is balanced by more snow.

The other part of the report's job is to make predictions about what will happen to the climate. In this, it illustrates a curious aspect of the science of climate change. Studying the climate reveals new, little-understood, mechanisms: as temperatures warm, they set off feedback effects that may increase, or decrease, warming. So, as understanding grows, predictions may become less, rather than more, certain. Thus the IPCC's range of predictions of the rise in the temperature by 2100 has increased from 1.4-5.8°C in the 2001 report to 1.1-6.4°C in this report.

That the IPCC should end up with a range that vast is not surprising given the climate's complexity. But it does leave plenty of scope for argument about whether it is worth trying to do anything about climate change.

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# The Richard Casement internship

Feb 8th 2007
From The Economist print edition

We invite applications for the 2007 Richard Casement internship. This is for a would-be journalist to spend three months of the summer working on the newspaper in London, writing about science and technology. Our aim is more to discover writing talent in a science student or scientist than scientific aptitude in a budding journalist. Applicants should write a letter introducing themselves, along with an original article of about 600 words that they think would be suitable for publication in the Science and technology section. They should be prepared to come for an interview in London or New York, at their own expense, but a small stipend will be paid to the successful candidate. Applications must reach us by February 22nd. They should be sent by e-mail to casement2007@economist.com

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A critic of Islam

# Dark secrets

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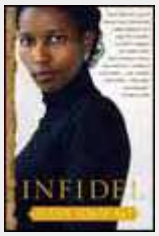
**Ayaan Hirsi Ali blames Islam for the miseries of the Muslim world. Her new autobiography shows that life is too complex for that**

Infidel
By Ayaan Hirsi Ali



*Free Press; 368 pages; $26 and £12.99*

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Eyevine

SAY what you will about Ayaan Hirsi Ali, she fascinates. The Dutch-Somali politician, who has lived under armed guard ever since a *fatwa* was issued against her in 2004, is a chameleon of a woman. Just 11 years after she arrived in the Netherlands from Africa, she rode into parliament on a wave of anti-immigrant sentiment, only to leave again last year, this time for America, after an uproar over lies she had told to obtain asylum.

Even the title of her new autobiography reflects her talent for reinvention. In the Netherlands, where Ms Hirsi Ali got her start campaigning against the oppression of Muslim women, the book has been published under the title “My Freedom”. But in Britain and in America, where she now has a fellowship at the conservative American Enterprise Institute, it is called “Infidel”. In it, she recounts how she and her family made the cultural odyssey from nomadic to urban life in Africa and how she eventually made the jump to Europe and international celebrity as the world's most famous critic of Islam.

Read as a modern coming-of-age story set in Africa, the book has a certain charm. Read as a key to the thinking of a woman who aspires to be the Muslim Voltaire, it is more problematic. The facts as Ms Hirsi

Ali tells them here do not fit well either with some of the stories she has told in the past or with her tendency in her political writing to ascribe most of the troubles of the Muslim world to Islam.

Ms Hirsi Ali's father, Hirsi Magan Isse, was one of the first Somalis to study overseas in Italy and America. He met his future wife, Asha, when she signed up for a literacy class he taught during Somalia's springtime of independence in the 1960s. The family's troubles began in 1969, the year Ms Hirsi Ali was born. That was also the year that Mohammed Siad Barre, a Somali army commander, seized power in a military coup. Hirsi Magan was descended from the traditional rulers of the Darod, Somalia's second biggest clan. Siad Barre, who hailed from a lesser Darod family, feared and resented Ms Hirsi Ali's father's family, she says. In 1972, Siad Barre had Hirsi Magan put in prison from which he escaped three years later and fled the country. Not until 1978 was the family reunited with him.

As a young woman, Ms Hirsi Ali's mother, Asha, does not seem to have inhabited “the virgin's cage” that the author claims imprisons Muslim women around the world. At the age of 15, she travelled by herself to Aden where she got a job cleaning house for a British woman. Despite her adventurous spirit, in Yemen and later in the Gulf she found herself drawn to the stern Wahhabi version of Islam that would later clash with the more relaxed interpretation of Islam favoured by Ms Hirsi Ali's father and many other Somalis. She and Hirsi Magan fell out not long after the family moved to Kenya in 1980. Hirsi Magan left to join a group of Somali opposition politicians in exile in Ethiopia and did not return to his family for ten years.

Ms Hirsi Ali says her mother had no idea how to raise her children in a foreign city. She frequently beat Ayaan and her sister, Haweya. Although they and their brother, Mahad, attended some of Nairobi's best schools, Haweya and Mahad dropped out early on. Ms Hirsi Ali herself meanwhile fell under the sway of the Muslim Brotherhood.

Some of the best passages in the book concern this part of her life. As a teenager, Ms Hirsi Ali chose to wear the all-encompassing black Arab veil, which was unusual in cosmopolitan Nairobi. “Weirdly, it made me feel like an individual. It sent out a message of superiority,” she writes. Even as she wore it, Ms Hirsi Ali was drawn in other directions. She read English novels and flirted with a boy. Young immigrants of any religion growing up with traditional parents in a modern society will recognise her confusion: “I was living on several levels in my brain. There was kissing Kennedy; there was clan honour; and there was Sister Aziza and God.”

Ms Hirsi Ali sounds less frank when she tells the convoluted story of how and why she came to seek asylum at the age of 22 in the Netherlands. She has admitted in the past to changing her name and her age, and to concocting a story for the Dutch authorities about running away from Somalia's civil war. (In fact she left from Kenya, where she had had refugee status for ten years.) She has since justified those lies by saying that she feared another kind of persecution: the vengeance of her clan after she ran away from an arranged marriage.

However, last May a Dutch television documentary suggested that while Ms Hirsi Ali did run away from a marriage, her life was in no danger. The subsequent uproar nearly cost Ms Hirsi Ali her Dutch citizenship, which may be the reason why she is careful here to re-state how much she feared her family when she first arrived in the Netherlands. But the facts as she tells them about the many chances she passed up to get out of the marriage—how her father and his clan disapproved of violence against women; how relatives already in the Netherlands helped her to gain asylum; and how her ex-husband peaceably agreed to a divorce—hardly seem to bear her out.

Ayaan Hirsi Ali is not the first person to use false pretences to try to find a better life in the West, nor will she be the last. But the muddy account given in this book of her so-called forced marriage becomes more troubling when one considers that Ms Hirsi Ali has built a career out of portraying herself as the lifelong victim of fanatical Muslims.

Another, even more disturbing story concerns her sister Haweya's sojourn in the Netherlands. In her earlier book, “The Caged Virgin”, which came out last year, Ms Hirsi Ali wrote that her sister came to the Netherlands to avoid being “married off”. In “Infidel”, however, she says Haweya came to recover from an illicit affair with a married man that ended in abortion. Ms Hirsi Ali helped Haweya make up another fabricated story that gained her refugee status, but the Netherlands offered her little respite. After another affair and a further abortion, Haweya was put into a psychiatric hospital. Back in Nairobi, she died from a miscarriage brought on by an episode of religious frenzy. “It was the worst news of my life,” Ms Hirsi Ali writes.

Mental illness, abortion, failed marriages, illicit affairs and differing interpretations of religion: much as she tries, the kind of problems that Ms Hirsi Ali describes in “Infidel” are all too human to be blamed entirely on Islam. Her book shows that her life, like those of other Muslims, is more complex than many people in the West may have realised. But the West's tendency to seek simplistic explanations is a weakness that Ms Hirsi Ali also shows she has been happy to exploit.

Infidel.
By Ayaan Hirsi Ali.
*Free Press; 368 pages; $26 and £12.99*

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American politics

# My life as an insider

Feb 8th 2007
From The Economist print edition

**Terry McAuliffe fails to spill the beans on the Clintons—and much else**

ONE month after the Senate voted on impeaching Bill Clinton in February 1999, the Clintons borrowed Jeffrey Katzenberg's house on Bald Eagle Mountain, Utah, for a skiing holiday. Each evening they would sit down and watch television. Hillary Clinton, commanding the remote control, clicked through every channel only to encounter anti-Clinton invective all over the place. Clinton murdered people! Clinton sold drugs! She eventually had to settle on the sports channel.

AFP

**Hardly Mac the Knife**

Terry McAuliffe, who joined the Clintons on the trip, has been a top Democratic fund-raiser and all-round fixer ever since he joined the Carter-Mondale campaign in 1980. He was Mr Clinton's senior moneyman (he even offered personally to guarantee the loan that the Clintons needed to buy their house in Chappaqua, having made a pile for himself in various business ventures) and he is now Mrs Clinton's campaign boss. If all goes well for her, “Mac”, as he likes to be called, could be at the centre of American politics for another decade.

What a Party! My Life Among Democrats: Presidents, Candidates, Donors, Activists, Alligators and Other Wild Animals
By Terry McAuliffe and Steve Kettmann

*Thomas Dunne; 406 pages; $24.95*

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This book contains a few good anecdotes like the one above (though one suspects that the television talking heads were talking more about womanising than murder and drug-dealing). Mr McAuliffe is also informative about his efforts to close the “infrastructure gap” between the Democratic National Committee and its Republican equivalent. He even offers yet one more reason to hate Barbra Streisand: she hates dogs.

But all in all this is a pretty feeble effort: Mr McAuliffe is clearly much better with money than he is with words. Mac is an inveterate name-dropper. He is also addicted to patting himself on the back: “Man, you got guts,” says an opponent on page 145; “I can't thank you enough for all you've done,” says Bill Clinton on page 167; and so on and so on. The basic thesis of the book can be summed up in a single phrase: isn't it wonderful that a boy from small-town New York made a lot of money, befriended the Clintons and got to hang out with the rich and famous?

But Mr McAuliffe does little to illuminate the process of which he was such an important part. He is too much of a player to admit that Democratic fund-raising is anything less than perfect: he dismisses complaints about the Lincoln Bedroom and fund-raising coffee mornings as Republican smear jobs. And he is too much of a partisan to throw much light on the issues at stake: the Republicans are always snobs and liars and the Democrats are always champions of the people against the powerful.

This is a pity. Mr McAuliffe's name will always be associated with two of the most important developments in recent American politics: the transformation of the Democratic Party into a money-machine that is just as powerful as the Republican version; and the further entrenchment of the dynastic principle at the very heart of modern politics.

These developments raise fascinating questions. How can the people's party preserve its soul while its leading politicians spend all their time hobnobbing with megabuck donors? (It would be interesting to know when Mrs Clinton last socialised with people who were not rolling in money.) And why is a populist republic so enamoured of political dynasties? Mr McAuliffe is far more successful as an enabler of these troubling developments than as an analyst of them.

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British political history

# First among equals

Feb 8th 2007
From The Economist print edition

SIR ROBERT WALPOLE is widely regarded as having been Britain's first prime minister. This well-researched biography by Edward Pearce, an accomplished political historian and biographer, provides a lively account of Walpole's public career. It charts his rise under Queen Anne and George I (including a spell in prison in the Tower of London in 1712 on charges of financial impropriety) to his appointment as paymaster-general in 1714. The equivalent of many millions of pounds of public money passed through Walpole's hands and he took full advantage of the opportunities it afforded for self-enrichment.

Walpole became prime minister in 1722 in the wake of the South Sea Bubble scandal. He has an undeserved reputation for financial wizardry, based upon his supposed expertise in rectifying the damage done by the bubble. In fact Walpole did not understand the speculation and was prevented from making a disastrous investment in the shares himself only by a shrewd adviser.

He fell from power in 1742, having served as prime minister for more than 20 years, a longer period in office than anyone has managed since. His government aspired to peace abroad and sound administration at home; less admirable was the Black Act of 1723, under which anyone who was convicted of blackening or disguising his face to hunt deer could be hanged.

The Great Man—Sir Robert Walpole: Scoundrel, Genius and Britain's First Prime Minister
By Edward Pearce

*Jonathan Cape; 485 pages; £25*

Buy it at Amazon.co.uk

The durable prime minister's greatest talent was his hold on power. His authority was founded on his mastery of the House of Commons, which he achieved using a mixture of “authority, charm and menace”. Careful dispensing of political patronage also helped. Walpole believed every man had his price; this he was prepared to pay, but in return he expected absolute loyalty. Those who crossed him or who failed to deliver what was expected of them were ruthlessly discarded. Here lies Walpole's legacy for, as Mr Pearce puts it, he “created the politics of the next hundred years”, perfecting the system of jobbery and rotten boroughs that was swept away only by the Reform Acts of the 19th century.

Walpole encountered increasing opposition the longer his regime continued. The second half of his period in office was characterised by ever more strident criticism. One of the delights of Mr Pearce's book is the chapter on the literary opposition to the prime minister. Jonathan Swift's “Gulliver's Travels” cruelly satirised Walpole's regime while John Gay's “The Beggar's Opera” delighted its huge audiences with its irreverent commentary on his cynical corruption. Alexander Pope and Henry Fielding also had much to say on Walpole's administration.

Mr Pearce makes only passing reference to what is, for many, Walpole's outstanding monument: the magnificent Palladian house he built at Houghton in Norfolk. Building it absorbed much of Walpole's energy and time between 1722 and 1735; it is said that each morning he opened letters from his agent at Houghton before turning to government business.

The author clearly admires his subject for his political longevity, his commitment to peace and his parliamentary and electoral management. Given how corrupt, repressive and touchy Walpole was, though, Mr Pearce says that “liking him is too difficult”.

The Great Man—Sir Robert Walpole: Scoundrel, Genius and Britain's First Prime Minister.
By Edward Pearce.
*Jonathan Cape; 485 pages; £25*

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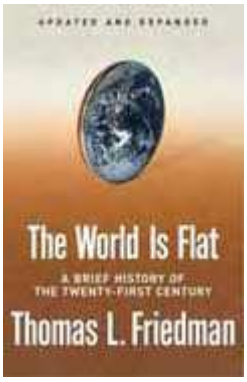
**Amazon worldwide bestsellers**

# The history boys (and one girl)

Feb 8th 2007
From The Economist print edition

**The history books that Americans buy reflect their concerns**




AMERICANS are worried about God, globalisation and their place in the world. That, at least, is the conclusion to be drawn from the global sale of history books through Amazon.com.

A new edition of Thomas Friedman's 2005 bestseller, “The World is Flat”, is there, along with Newt Gingrich on the role of religious faith in America and Michael Oren and Mark Steyn (interestingly, both outsiders) on the consequences of American behaviour abroad, especially in the Middle East.

These books all came out within the past six months. Big names and big subjects tend to generate big publicity around publication time, but it takes an additional, often indefinable something for a book to continue selling. James Loewen's “Lies My History Teacher Told Me” is nearly a decade old, and still sells hundreds of copies each week.

In an easy, readable style, the author vets ten topics (from Christopher Columbus to the Vietnam war) and bewails how American textbooks distort them. Although he sometimes adopts a tone of high political correctness, he often proves the textbooks and teachers wrong. For readers who are children at heart, what could be more appealing?

**1. The World is Flat [Updated and Expanded]: A Brief History of the Twenty-First Century**
by Thomas L. Friedman

Click to buy from Amazon.com or Amazon.co.uk

**2. Palestine: Peace Not Apartheid**
by Jimmy Carter

Click to buy from Amazon.com or Amazon.co.uk

**3. Power, Faith, and Fantasy: America in the Middle East, 1776 to the Present**
by Michael B. Oren

Click to buy from Amazon.com or Amazon.co.uk

**4. America Alone: The End of the World as We Know It**
by Mark Steyn

Click to buy from Amazon.com or Amazon.co.uk

**5. A People’s History of the United States: 1492-Present**
by Howard Zinn

Click to buy from Amazon.com or Amazon.co.uk

**6. Medical Apartheid: The Dark History of Medical Experimentation on Black Americans from Colonial Times to the Present**
by Harriet A. Washington

Click to buy from Amazon.com or Amazon.co.uk

**7. Rediscovering God in America: Reflections on the Role of Faith in Our Nation's History and Future**
by Newt Gingrich

Click to buy from Amazon.com or Amazon.co.uk

**8. Six Frigates: The Epic History of the Founding of the U.S. Navy**
by Ian W. Toll

Click to buy from Amazon.com or Amazon.co.uk

**9. Lies My Teacher Told Me: Everything Your American History Textbook Got Wrong**
by James W. Loewen

Click to buy from Amazon.com or Amazon.co.uk

**10. The Cartoon History of the Modern World Part 1: From Columbus to the U.S. Constitution**
by Larry Gonick

Click to buy from Amazon.com or Amazon.co.uk

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**Jacopo Tintoretto**

# A tribute well earned

Feb 8th 2007 | MADRID
From The Economist print edition

**The master of the Venetian Renaissance finally gets a show he deserves**

JACOPO TINTORETTO, one of the great masters of Venetian Renaissance painting, has been neglected by critics, curators and gallery-goers for decades. Visitors to Venice often return with their heads full of the splendours of his religious paintings in the Scuola di San Rocco, one of the wonders in the history of art. But, once back home, there is little to sustain their interest. The last major exhibition devoted solely to Tintoretto was 70 years ago—and that was in Venice.

Museo Nacional del Prado

**If I were a rich man**

A calculated effort to restore Tintoretto's reputation has begun at the Museo Nacional del Prado in Madrid, where an ambitious exhibition of his work was opened recently by the king of Spain and the president of Italy. The intention is to reinstate Tintoretto alongside celebrated figures in whose shadow he has languished, such as Titian and Giorgione. Critics sometimes jeer at the phenomenon of blockbuster exhibitions of Old Masters and ageing Impressionists, but Miguel Falomir, the chief curator of the Prado exhibition, declares that Tintoretto not only deserves a show, he requires it.

To mount an exhibition outside Venice is an act of courage because Tintoretto is the most Venetian of his great contemporaries. He was born there, and his work appeared in no fewer than 53 Venetian churches, palaces and religious fraternities known as *scuole*. The vast majority of it still hangs there and much of the best of it is too big or too integral to a building to be moved. When the Prado proposed collaborating with other national galleries, as is common now among museums, they were told that other curators thought it was impossible and declined to join in. (Mr Falomir prefers not to name the faint-hearted.)

Tintoretto was a bold painter with a huge and variable output. Best of all are large religious narratives, crowded with sculptured figures painted with astonishing energy in dramatic colours emphasised by *chiaroscuro*, or light and shade. There are sound reasons for holding a show of his work in Madrid. Velazquez was an admirer and bought Tintorettos for the king of Spain when he visited Venice in 1650. Six exquisite roof panels and a fine portrait from that purchase are to be seen now in Madrid. The Prado provides ten of the show's 65 works, though it has others in its collection that Mr Falomir did not consider good enough.

The exhibition, which is hung in the Prado's long central gallery—it measures 112 metres (367 feet)—begins with a self-portrait of the artist in his late 20s. He shows himself in three-quarter profile, with moustache, beard and carefully combed sideburns, but the most striking feature is the big, brown eyes staring right back at the viewer. It is the face of an assertive, single-minded man.

He was born in 1518, when Titian was in his early 30s. An early anecdote suggests that he was briefly a

student of Titian's before the master expelled him from the studio—out of envy for his precocious talent, so the story goes, and, since Titian was not a generous master, it could be true. Tintoretto cannot have been entirely self-taught but he developed personal techniques that set him apart. For example, he built models and shone light through their windows, to study the way it fell; and he suspended models from a ceiling so that he could draw them in flight. A flying man was a significant figure in “Miracle of the Slave”, the painting that established his fame in 1548—and the painting that Mr Falomir lusted after more than any other. At four metres by five and a half, it is too big to be transported from Venice.

Some of the finest religious narratives have travelled, however. There are two Last Suppers. One is sombre with classical allegories; the other (pictured below), from the church of San Trovaso, is Tintoretto on incomparable form, placing biblical stories in the domestic surroundings of 16th-century Venice. The supper is of bread rolls on a crumpled cloth, and, as Christ reveals Judas's betrayal, one disciple knocks over his wicker chair while reaching for the flask of wine. There is a red darned patch on the white sock of another disciple, and a pile of coats, bags and a book on a stool. No mythology, no piety—just a dramatic story.

Mr Falomir chose the best of Tintoretto from the best galleries in Europe and North America: there is a luminous “Susanna and the Elders” from Vienna, and “The Origins of the Milky Way” from London, painted more directly in the style of Titian when Tintoretto was trying to win overseas commissions after the great man's death. There are portraits too, though none as interesting as the self-portraits. The exhibition ends with the artist in 1588 when he was 70, six years before his death. His hair is grey; his cheeks and eyes sunken; his look faintly melancholic, but unapologetic—a man who says you must take him as you find him.

The Prado's Tintoretto exhibition is a significant symbol of its transformation from an academic institution with a brilliant permanent collection into a national museum competing with other great galleries for shows of celebrated painters. Later this year, new exhibition space is to be opened. It seems that Spanish politicians look kindly on the regime of the director, Miguel Zugaza Miranda, who, unlike his predecessors, recently survived a change of government.

The Tintoretto exhibition sits confidently in the environment in which art and tourism mingle. But has Mr Falomir achieved his aim and restored Tintoretto's reputation? He has dusted it off, patched and cleaned it where necessary. As the curator himself admits: “No exhibition can replace a tour of Venice.” But this rich and rewarding show endorses Tintoretto's greatness, and that is what the curator intended.

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“Tintoretto” is at the Museo Nacional del Prado, Madrid, until May 13th

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About sponsorship

# David Rattray

Feb 8th 2007
From The Economist print edition

**David Rattray, master-storyteller of the Zulu war, died on January 26th, aged 48**

Jane Flanagan pics

Get article background

ON JANUARY 22nd 1879, Private Samuel Wassall nearly met his maker at the Buffalo river. He was deep in that whirlpool of drowning men and horses, forcing his own mount across, when he heard a gurgling behind him. It came from Thomas Westwood, a private in the same Staffordshire regiment. Westwood was going under. Without hesitation Wassall swam his horse back, tied it up on the Zulu-held bank of the river, got Westwood to safety, crossed again to get his horse and—as Zulu assegais whistled into the water on every side of him—made it back himself to the Natal side. He lived, and he won the Victoria Cross, one of 14 awarded that day at the Battle of Isandlwana.

Meanwhile, up on a high promontory above the rocky plain, Captain Younghusband and his men were making a last stand. They had fought till they were exhausted. Younghusband now knew there was no ammunition left for their Martini-Henry rifles. He shook each of his men by the hand and said goodbye. One by one they fell to the assegais. But suddenly Younghusband spotted, from high on the mountain, one ammunition cart left behind, and raced down towards it. The Zulus couldn't believe what they were seeing. Before long, one of them killed Younghusband with a rifle shot—and then they carried him aloft on their war-shields back to the crag on which his men lay dead and dying, because he was a hero to them.

David Rattray had dozens more such stories. Of Charles Raw, chasing after a herd of cattle on “a hellish hot day”, suddenly arriving at the edge of a ravine and seeing, as far as the eye could see, thousands of Zulus squatting in absolute silence on their war-shields. Of Teignmouth Melvill, washed downstream in the rapids of the Buffalo river but still holding the Queen's Colours high above his head. Of Charles Harford, who found the case and pole of those Colours in the river mud—the embroidery torn off by the water—and who, during one sortie, had wandered off to observe a strange new species of beetle and capture it in a matchbox.

Mr Rattray, an entomologist by training, liked Harford especially. But he knew them all. He had lived with them, read their journals, and had come to see the Anglo-Zulu war through their individual eyes and voices. In 1989, after managing a game park for some years, he built a house at Fugitives' Drift that overlooked the river and the battlefield, and made the war his life.

In the combatants' footsteps he would tramp across the rocky thorn-veld of KwaZulu-Natal, taking with him a contingent of overweight tourists mopping their brows and collapsing on camping chairs. To them he would point out the white stone cairns where men had fallen, the caves where others had hidden, or

the lines at Rorke's Drift where the British, in an extraordinary stand the day after Isandlwana, had defended themselves in a field hospital behind walls of mealie bags and biscuit tins. He would talk for hours in his soft, fast, urgent voice, waving his stick over the shimmering battlefield. He could imitate the orders barked to a Victorian rocket detachment (“Point the rocket at the advancing savages. Aim the apparatus. Pull the string and stand back!”) and the rushing, hooting “Usuthu! Usuthu!” of 20,000 warriors attacking. As his stories unfolded, battle-hardened generals would find themselves in tears.

## The day of the dead moon

The Zulu war ended, merely six months after it began, with the complete surrender of the Zulus and their forced incorporation into a federal South Africa. But Mr Rattray was no white triumphalist. He cared equally, and knew as much, about the Zulu side. He would remind his listeners that January 22nd 1879 was the “day of the dead moon”, an eclipse of the sun, on which Zulus were not meant to fight; that was why they had crouched in the ravine and waited. And when the young warriors disembowelled every British body, this was not gratuitous mutilation: they were helping the spirit to escape.

Brought up in segregated suburbs and schools, it was some years before he got to know Zulus. But his family bought land around the battlefield, and as a student he began to wander there with a Zulu friend, talking to farmers about their ancestral memories of the war and picking up expertly their musical, clicking language. When he settled there, local people in KwaZulu-Natal called him a “white Zulu”: their friend, and the best exponent living of the native tradition of telling stories. Although he invoked one of the bloodiest clashes between black and white, he did it with such sympathy that he became a symbol of reconciliation in South Africa.

All the more awful, then, that he was killed by Zulus. The details emerged in court from 23-year-old Fethe Nkwanyana, unmoving and unblinking before the cameras. Somebody had told him that Mr Rattray had money. He had therefore gone with five others to Fugitives' Drift on the evening of January 26th to rob him. They were all armed with guns; he himself had a Norinco pistol. But it was Banozi Ndlovu who shot Mr Rattray as he challenged them. They all ran away empty-handed.

Mr Rattray had spent his life recovering the unheard voices of South Africa's past. This one, a voice heard too often in modern South Africa, he did not live to hear.

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# Overview

Feb 8th 2007
From The Economist print edition

**Oil prices** rose in response to colder weather in America. The benchmark price for a barrel of West Texas Intermediate climbed above $59 on February 7th.

**American** companies, excluding farms, added 111,000 workers to their payrolls in January. The figures for November and December were revised up by 81,000 in total. The unemployment rate edged up to 4.6% in January.

**Labour productivity** in America's non-farm businesses rose at an annual rate of 3.0% in the fourth quarter, according to preliminary estimates. In 2006 as a whole, the increase in output per hour was just 2.1%, the weakest since 1997.

In the **euro area** the volume of retail trade rose by 0.3% in December, a 2.1% increase on a year earlier. **German** industrial output fell by 0.5% in December, following a 2.0% rise in November.

In **Britain** industrial production dropped by 0.1% in December, leaving it only 0.5% higher than a year earlier.

**Indonesia's** central bank cut its key interest rate to 9.25%, its eighth cut in as many months. Inflation was 6.3% in the year to January, down from 17% a year earlier.

The **New York Stock Exchange** set a record on February 7th, when the Dow Jones Industrial average briefly rose above 12,700 during trading. In **London** the FTSE 100 index reached its highest level for six years.

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About sponsorship

# Output, prices and jobs

Feb 8th 2007
From The Economist print edition

## Output, prices and jobs

% change on year ago

| | Gross domestic product | | | | Industrial production | Consumer prices | | | Unemployment |
|---|---|---|---|---|---|---|---|---|---|
| | latest | qtr* | 2006† | 2007† | latest | latest | year ago | 2007† | rate‡, % |
| United States | +3.4 Q4 | +3.5 | +3.4 | +2.6 | +3.0 Dec | +2.5 Dec | +3.4 | +1.9 | 4.6 Jan |
| Japan | +1.6 Q3 | +0.8 | +2.1 | +1.9 | +4.6 Dec | +0.3 Dec | –0.4 | +0.4 | 4.1 Dec |
| China | +10.4 Q4 | na | +10.5 | +9.4 | +14.9 Nov | +2.8 Dec | +1.6 | +2.1§ | 9.8 2006 |
| Britain | +3.0 Q4 | +3.2 | +2.7 | +2.5 | +0.5 Dec | +3.0 Dec** | +1.9 | +2.2 | 5.5 Nov†† |
| Canada | +2.5 Q3 | +1.7 | +2.8 | +2.3 | –2.2 Nov | +1.6 Dec | +2.2 | +1.7 | 6.1 Dec |
| Euro area | +2.7 Q3 | +2.0 | +2.7 | +2.0 | +2.5 Nov | +1.9 Jan | +2.4 | +2.0 | 7.5 Dec |
| Austria | +3.2 Q3 | +3.6 | +3.1 | +2.5 | +5.6 Nov | +1.5 Dec | +1.6 | +1.7 | 4.6 Jan |
| Belgium | +3.1 Q3 | +2.5 | +2.7 | +2.1 | nil Nov | +1.7 Jan | +2.6 | +1.9 | 11.7 Dec‡‡ |
| France | +1.9 Q3 | nil | +2.0 | +2.0 | –1.1 Nov | +1.5 Dec | +1.5 | +1.4 | 8.6 Dec |
| Germany | +2.8 Q3 | +2.6 | +2.6 | +1.7 | +5.5 Dec | +1.6 Jan | +2.1 | +2.1 | 9.5 Jan |
| Greece | +4.4 Q3 | na | +4.1§ | +3.5§ | –1.8 Nov | +2.9 Dec | +3.6 | +2.8§ | 8.3 Q3 |
| Italy | +1.7 Q3 | +1.1 | +1.8 | +1.3 | +2.2 Nov | +1.7 Jan | +2.2 | +1.9 | 6.8 Q3 |
| Netherlands | +2.7 Q3 | +2.8 | +2.8 | +2.5 | +3.7 Nov | +1.1 Dec | +2.0 | +1.8 | 5.2 Dec†† |
| Spain | +3.8 Q3 | +3.6 | +3.7 | +3.0 | +4.2 Nov | +2.7 Dec | +3.7 | +2.6 | 8.5 Dec |
| Czech Republic | +5.8 Q3 | +5.6 | +6.0 | +4.8 | +7.6 Nov | +1.7 Dec | +2.2 | +3.3 | 7.7 Dec |
| Denmark | +3.2 Q3 | +2.9 | +3.5 | +2.4 | +0.6 Dec | +1.8 Dec | +2.2 | +1.9 | 3.9 Dec |
| Hungary | +3.8 Q3 | +4.2 | +3.7 | +2.4 | +14.0 Dec | +6.5 Dec | +3.3 | +5.9 | 7.5 Dec†† |
| Norway | +2.6 Q3 | +5.2 | +2.5§ | +2.3§ | –2.0 Dec | +2.2 Dec | +1.8 | +2.6§ | 2.9 Dec†† |
| Poland | +5.8 Q3 | na | +5.3 | +4.7 | +5.7 Dec | +1.4 Dec | +0.7 | +2.5§ | 14.9 Dec‡‡ |
| Russia | +6.5 Q3 | na | +6.7 | +6.5 | +1.9 Dec | +8.0 Jan | +10.6 | +9.2§ | 6.9 Dec‡‡ |
| Sweden | +4.4 Q3 | +4.1 | +4.6 | +3.5 | +10.3 Dec | +1.6 Dec | +0.9 | +1.8 | 4.6 Dec‡‡ |
| Switzerland | +2.4 Q3 | +1.5 | +2.7 | +2.0 | +8.2 Q3 | +0.1 Jan | +1.3 | +0.9 | 3.3 Jan‡‡ |
| Turkey | +3.4 Q3 | na | +5.2 | +4.0 | +2.5 Dec | +9.9 Jan | +7.9 | +8.6§ | 9.1 Q3‡‡ |
| Australia | +2.2 Q3 | +1.2 | +2.5 | +2.8 | +0.9 Q3 | +3.3 Q4 | +2.8 | +2.9 | 4.5 Jan |
| Hong Kong | +6.8 Q3 | +14.8 | +6.0 | +5.0 | –0.6 Q3 | +2.3 Dec | +1.3 | +2.5§ | 4.4 Dec†† |
| India | +9.2 Q3 | na | +8.3 | +7.4 | +14.4 Nov | +6.9 Dec | +5.6 | +6.1§ | 7.6 2006 |
| Indonesia | +5.5 Q3 | na | +5.3 | +5.8 | +24.2 Nov | +6.3 Jan | +17.0 | +6.6§ | 10.3 2005 |
| Malaysia | +5.9 Q3 | na | +5.5 | +5.2 | +6.3 Dec | +3.1 Dec | +3.5 | +3.4§ | 3.1 Q3 |
| Pakistan | +6.6 2006§§ | na | +6.2§ | +6.6§ | +6.8 Sep | +8.9 Dec | +8.5 | +7.0§ | na |
| Singapore | +5.9 Q4 | +7.6 | +7.7 | +5.0 | +5.1 Dec | +0.8 Dec | +1.3 | +1.0§ | 2.6 Q4 |
| South Korea | +4.0 Q4 | +3.4 | +4.9 | +4.2 | +2.3 Dec | +1.7 Jan | +2.2 | +2.3§ | 3.3 Dec |
| Taiwan | +5.0 Q3 | na | +4.1 | +3.9 | –1.7 Dec | +0.4 Jan | +2.7 | +1.5§ | 3.9 Dec |
| Thailand | +4.7 Q3 | +6.0 | +4.3 | +4.3 | +7.0 Dec | +3.0 Jan | +5.9 | +3.6§ | 1.2 Nov |
| Argentina | +8.7 Q3 | +10.8 | +7.9 | +6.3 | +3.8 Nov | +9.7 Jan | +12.1 | +9.8§ | 10.2 Q3‡‡ |
| Brazil | +3.2 Q3 | +1.4 | +3.0 | +3.3 | +2.8 Dec | +3.1 Dec | +5.7 | +3.7§ | 8.4 Dec‡‡ |
| Chile | +2.9 Q3 | –0.2 | +4.7 | +5.3 | +1.2 Dec | +2.8 Jan | +4.1 | +2.3§ | 6.0 Dec†††‡ |
| Colombia | +7.7 Q3 | +8.1 | +5.1 | +4.5 | +17.4 Oct | +4.7 Jan | +4.6 | +4.2§ | 11.0 Nov‡‡ |
| Mexico | +4.6 Q3 | +4.1 | +4.4 | +3.2 | +4.8 Nov | +4.1 Dec | +3.3 | +3.8§ | 3.5 Dec‡‡ |
| Venezuela | +10.2 Q3 | na | +7.8 | +5.5 | +12.2 Sep | +18.4 Jan | +13.1 | +17.0§ | 10.1 Q3‡‡ |
| Egypt | +7.1 Q3 | na | +5.5 | +5.4 | +4.0 2005 | +12.4 Dec | +3.1 | +6.5§ | 10.9 Q2‡‡ |
| Israel | +4.6 Q3 | –1.1 | +4.2 | +4.2 | +13.2 Nov | –0.1 Dec | +2.4 | +1.7§ | 8.3 Q3 |
| Saudi Arabia | +5.3 2006§ | na | +5.3§ | +5.4§ | na | +2.8 Nov | +1.1 | +2.0§ | na |
| South Africa | +4.5 Q3 | +4.7 | +4.3 | +4.2 | +5.4 Nov | +5.8 Dec | +3.6 | +5.6§ | 25.6 Mar‡‡ |
| **MORE COUNTRIES** Data for the countries below are not provided in printed editions of *The Economist* | | | | | | | | | |
| Estonia | +11.6 Q3 | +11.7 | +10.7§ | +8.9§ | +5.7 Dec | +5.1 Jan | +4.7 | +3.8§ | 4.5 Nov |
| Finland | +5.8 Q3 | +3.6 | +4.5§ | +2.7§ | +5.8 Dec | +2.2 Dec | +1.0 | +1.9§ | 7.3 Dec |
| Iceland | +0.3 Q3 | +0.4 | +3.7§ | +0.7§ | na | +6.9 Jan | +4.4 | +5.4§ | 1.1 Nov‡‡ |
| Ireland | +7.7 Q3 | +10.8 | +5.8§ | +5.3§ | –10.8 Nov | +4.9 Dec | +2.5 | +3.4§ | 4.5 Jan |
| Latvia | +11.8 Q3 | na | +10.8§ | +8.0§ | +0.7 Nov | +6.8 Dec | +7.0 | +5.2§ | 6.2 Nov |
| Lithuania | +6.6 Q4 | nil | +7.3§ | +6.5§ | na | +4.5 Dec | +3.0 | +4.4§ | 5.7 Dec |
| Luxembourg | +5.4 Q3 | +4.1 | +5.5§ | +4.3§ | +3.8 Oct | +2.3 Dec | +2.5 | +1.8§ | 4.8 Dec‡‡ |
| New Zealand | +1.3 Q3 | +1.0 | +1.9§ | +1.8§ | –1.4 Q3 | +2.6 Q4 | +3.1 | +3.0§ | 3.7 Q4 |
| Peru | +6.9 Nov | na | +6.0 | +5.4 | +3.0 Nov | +0.6 Jan | +1.9 | +2.2§ | 7.5 Dec‡‡ |
| Philippines | +4.8 Q3 | +1.3 | +5.5 | +5.3 | –19.2 Oct | +3.9 Jan | +6.7 | +5.1§ | 8.0 Q3‡‡ |
| Portugal | +1.5 Q3 | –0.6 | +1.2§ | +1.4§ | +3.2 Dec | +2.5 Dec | +2.6 | na | 7.4 Q3‡‡ |
| Slovakia | +9.8 Q3 | na | +7.5§ | +6.1§ | +9.8 Nov | +4.2 Dec | +3.7 | na | 12.3 Nov |
| Slovenia | +5.6 Q3 | na | +4.5§ | +4.0§ | +8.3 Nov | +2.8 Dec | +2.3 | na | 8.6 Nov‡‡ |

*% change on previous quarter, annual rate. †The Economist poll. ‡National definitions. §Economist Intelligence Unit estimate/forecast. **RPI inflation rate 4.4% in Dec. ††Latest three months. ‡‡Not seasonally adjusted. §§Year ending June.

**Sources:** National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

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# The Economist commodity-price index

Feb 8th 2007
From The Economist print edition

## *The Economist* commodity-price index

2000=100

| | Jan 30th | Feb 6th* | % change on one month | % change on one year |
|---|---|---|---|---|
| **Dollar index** | | | | |
| All items | 184.9 | 182.9 | +3.4 | +14.9 |
| Food | 155.5 | 155.5 | +3.6 | +13.8 |
| Industrials | | | | |
| All | 223.0 | 218.3 | +3.2 | +15.9 |
| Nfa† | 155.2 | 155.0 | +5.0 | +2.2 |
| Metals | 259.9 | 252.8 | +2.6 | +21.4 |
| **Sterling index** | | | | |
| All items | 143.0 | 140.9 | +1.9 | +1.7 |
| **Euro index** | | | | |
| All items | 132.0 | 130.6 | +3.8 | +6.2 |
| **Gold** | | | | |
| $ per oz | 645.67 | 653.05 | +7.2 | +17.3 |
| **West Texas Intermediate** | | | | |
| $ per barrel | 56.81 | 59.07 | +6.3 | −6.1 |

*Provisional †Non-food agriculturals.

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# The Economist poll of forecasters

Feb 8th 2007
From The Economist print edition

**_The Economist_ poll of forecasters, February averages** (previous month's, if changed)

| | Real GDP, % change Low/high range | | Real GDP, % change average | | Consumer prices % increase | | Current account % of GDP | |
|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 |
| Australia | 2.3/2.5 | 2.3/3.5 | 2.5 (2.7) | 2.8 (3.2) | 3.6 | 2.9 | −5.4 (−5.6) | −5.0 (−5.2) |
| Belgium | 2.0/3.0 | 1.9/2.2 | 2.7 | 2.1 (1.9) | 2.0 | 1.9 (2.0) | 2.1 | 2.0 (1.9) |
| Britain | 2.4/2.7 | 2.1/2.9 | 2.7 | 2.5 | 2.4 | 2.2 | −2.7 | −2.8 |
| Canada | 2.7/2.8 | 1.8/2.9 | 2.8 | 2.3 | 2.0 (2.2) | 1.7 (2.1) | 1.6 | 1.1 (0.9) |
| France | 2.0/2.1 | 1.5/2.4 | 2.0 (2.3) | 2.0 | 1.8 (1.8) | 1.4 | −1.6 (−1.5) | −1.1 (−1.2) |
| Germany | 2.3/2.7 | 1.0/2.2 | 2.6 | 1.7 (1.4) | 1.7 | 2.1 (2.3) | 4.0 (3.6) | 4.1 (3.7) |
| Italy | 1.6/1.8 | 0.8/1.7 | 1.8 | 1.3 (1.2) | 2.2 | 1.9 | −2.0 (−1.8) | −1.7 |
| Japan | 2.0/2.2 | 1.4/2.5 | 2.1 (2.7) | 1.9 (2.1) | 0.2 (0.3) | 0.4 | 3.8 (3.6) | 3.8 (3.6) |
| Netherlands | 2.7/2.9 | 2.0/2.9 | 2.8 | 2.5 (2.2) | 1.4 | 1.8 | 7.9 (6.3) | 7.6 (5.7) |
| Spain | 3.4/3.8 | 2.4/3.4 | 3.7 | 3.0 (2.8) | 3.4 (3.5) | 2.6 | −8.5 (−8.1) | −8.5 (−7.8) |
| Sweden | 4.3/5.1 | 2.8/4.0 | 4.6 | 3.5 (3.1) | 1.4 | 1.8 | 6.9 (6.4) | 6.3 (5.9) |
| Switzerland | 2.1/3.0 | 1.5/2.3 | 2.7 | 2.0 | 1.0 | 0.9 (1.2) | 15.3 (13.5) | 14.0 |
| United States | 3.3/3.4 | 2.0/3.1 | 3.4 | 2.6 (2.3) | 3.2 (3.4) | 1.9 (2.3) | −6.6 | −6.1 (−6.5) |
| Euro area | 2.5/2.7 | 1.7/2.3 | 2.7 | 2.0 | 2.2 | 2.0 | −0.3 (−0.4) | −0.1 |

**Sources:** ABN AMRO, BNP Paribas, Citigroup, Decision Economics, Deutsche Bank, Economist Intelligence Unit, Goldman Sachs, HSBC Securities, KBC Bank, JPMorgan Chase, Morgan Stanley, Scotiabank, UBS

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About sponsorship

# Trade, exchange rates, budget balances and interest rates

Feb 8th 2007
From The Economist print edition

## Trade, exchange rates, budget balances and interest rates

| | Trade balance* latest 12 months, $bn | Current-account balance latest 12 months, $bn | Current-account balance % of GDP 2007† | Currency units, per $ Feb 7th | Currency units, per $ year ago | Budget balance % of GDP 2007‡ | Interest rates, % 3-month latest | Interest rates, % 10-year gov't bonds, latest |
|---|---|---|---|---|---|---|---|---|
| United States | −837.2 Nov | −880.3 Q3 | −6.1 | – | – | −2.2 | 5.24 | 4.74 |
| Japan | +79.6 Nov | +171.1 Nov | +3.8 | 121 | 119 | −4.9 | 0.45 | 1.73 |
| China | +177.5 Dec | +160.8 2005 | +6.7 | 7.75 | 8.05 | −1.6 | 2.90 | 3.16 |
| Britain | −152.2 Nov | −69.7 Q3 | −2.8 | 0.51 | 0.57 | −2.7 | 5.58 | 4.95 |
| Canada | +49.8 Nov | +28.9 Q3 | +1.1 | 1.18 | 1.15 | 0.8 | 4.17 | 4.13 |
| Euro area | −15.7 Nov | −31.4 Nov | −0.1 | 0.77 | 0.84 | −1.5 | 3.78 | na |
| Austria | −1.1 Nov | +12.2 Q3 | +1.4 | 0.77 | 0.84 | −1.1 | 3.78 | 4.02 |
| Belgium | +14.8 Nov | +6.8 Sep | +2.0 | 0.77 | 0.84 | 0.1 | 3.84 | 4.04 |
| France | −36.1 Nov | −43.0 Nov | −1.1 | 0.77 | 0.84 | −2.6 | 3.78 | 4.03 |
| Germany | +206.0 Dec | +121.5 Nov | +4.1 | 0.77 | 0.84 | −1.4 | 3.78 | 3.98 |
| Greece | −43.4 Nov | −28.8 Nov | −7.0‡ | 0.77 | 0.84 | −2.9 | 3.78 | 4.24 |
| Italy | −27.1 Nov | −43.5 Nov | −1.7 | 0.77 | 0.84 | −3.2 | 3.78 | 4.21 |
| Netherlands | +39.4 Nov | +63.2 Q3 | +7.6 | 0.77 | 0.84 | 0.6 | 3.78 | 4.01 |
| Spain | −112.8 Nov | −103.9 Oct | −8.5 | 0.77 | 0.84 | 0.3 | 3.78 | 4.03 |
| Czech Republic | +2.0 Dec | −5.2 Q3 | −2.7 | 21.6 | 23.8 | −4.2 | 2.59 | 3.72 |
| Denmark | +6.9 Nov | +6.7 Dec | +2.7 | 5.73 | 6.25 | 3.5 | 3.96 | 3.98 |
| Hungary | −2.7 Dec | −6.9 Q3 | −5.9 | 194 | 211 | −7.1 | 8.17 | 7.25 |
| Norway | +57.3 Dec | +56.0 Q3 | +17.5‡ | 6.23 | 6.73 | 19.3 | 4.14 | 4.48 |
| Poland | −4.1 Nov | −6.5 Nov | −2.3 | 2.97 | 3.20 | −2.5 | 4.20 | 5.16 |
| Russia | +140.8 Nov | +95.6 Q4 | +7.3 | 26.5 | 28.3 | 6.0 | 10.50 | 6.24 |
| Sweden | +20.7 Dec | +26.2 Q3 | +6.3 | 7.00 | 7.75 | 2.9 | 2.99 | 3.89 |
| Switzerland | +9.4 Dec | +105.9 Q3 | +14.0 | 1.24 | 1.30 | 1.2 | 2.21 | 2.54 |
| Turkey | −51.9 Dec | −33.7 Nov | −6.6 | 1.40 | 1.33 | −2.4 | 18.92 | 18.58 |
| Australia | −9.5 Dec | −39.5 Q3 | −5.0 | 1.28 | 1.35 | 1.3 | 6.38 | 5.80 |
| Hong Kong | −17.9 Dec | +19.2 Q3 | +9.3 | 7.81 | 7.76 | 1.0 | 4.15 | 4.17 |
| India | −51.7 Dec | −13.7 Q3 | −2.2 | 44.1 | 44.2 | −4.3 | 7.54 | 7.94 |
| Indonesia | +39.8 Dec | +7.0 Q3 | +1.4 | 9,039 | 9,265 | −0.9 | 9.26 | 6.21§ |
| Malaysia | +28.7 Nov | +22.2 Q3 | +11.1 | 3.49 | 3.73 | −4.3 | 3.68 | 5.34§ |
| Pakistan | −12.9 Dec | −6.0 Q3 | −5.4‡ | 60.8 | 59.9 | −4.6 | 10.27 | 6.75§ |
| Singapore | +33.1 Dec | +39.0 Q3 | +25.2 | 1.53 | 1.63 | 0.3 | 3.38 | 3.16 |
| South Korea | +16.4 Jan | +6.1 Dec | nil | 934 | 972 | 0.4 | 4.96 | 5.04 |
| Taiwan | +10.9 Jan | +26.3 Q3 | +5.0 | 33.0 | 32.3 | −2.2 | 1.82 | 2.07 |
| Thailand | +2.2 Dec | +3.2 Dec | nil | 34.4 | 39.7 | −1.2 | 5.03 | 4.71 |
| Argentina | +12.4 Dec | +6.7 Q3 | +1.6 | 3.10 | 3.08 | 1.0 | 9.81 | na |
| Brazil | +45.8 Jan | +13.5 Dec | +0.3 | 2.08 | 2.19 | −2.2 | 12.93 | 6.16§ |
| Chile | +23.9 Jan | +5.2 Q3 | +2.2 | 548 | 531 | 4.4 | 5.04 | 5.37§ |
| Colombia | +0.3 Oct | −2.3 Q3 | −2.1 | 2,237 | 2,259 | −1.5 | 6.90 | 6.22§ |
| Mexico | −5.8 Dec | −1.3 Q3 | −1.1 | 10.9 | 10.5 | −0.4 | 7.05 | 7.79 |
| Venezuela | +36.8 Q3 | +29.7 Q3 | +10.1 | 4,228 | 2,652 | −3.1 | 10.15 | 6.55§ |
| Egypt | −11.1 Q2 | +3.5 Q2 | +1.1 | 5.70 | 5.74 | −8.0 | 9.16 | 5.38§ |
| Israel | −7.9 Dec | +6.7 Q3 | +1.5 | 4.24 | 4.72 | −2.8 | 4.55 | 5.04 |
| Saudi Arabia | +165.7 2006 | +90.0 2005 | +25.6‡ | 3.75 | 3.75 | 20.4 | 4.94 | na |
| South Africa | −9.8 Dec | −13.5 Q3 | −4.9 | 7.18 | 6.22 | −2.0 | 9.40 | 7.68 |
| **MORE COUNTRIES** | Data for the countries below are not provided in printed editions of *The Economist* | | | | | | | |
| Estonia | −3.3 Nov | −2.1 Nov | −12.7‡ | 12.0 | 13.1 | 1.3 | na | na |
| Finland | +11.7 Nov | +12.3 Nov | +5.6‡ | 0.77 | 0.84 | 2.3 | 3.75 | 4.05 |
| Iceland | −1.9 Nov | −3.9 Q3 | −16.2‡ | 67.9 | 63.0 | 2.1 | 15.01 | na |
| Ireland | +35.3 Nov | −6.5 Q3 | −4.8‡ | 0.77 | 0.84 | 0.2 | 3.78 | 4.03 |
| Latvia | −4.7 Nov | −3.9 Nov | −19.5‡ | 0.54 | 0.58 | −1.2 | 4.10 | na |
| Lithuania | −5.0 Nov | −3.3 Nov | −9.5‡ | 2.65 | 2.89 | −0.5 | 3.83 | na |
| Luxembourg | −5.5 Nov | +4.8 Q3 | na | 0.77 | 0.84 | −0.8 | 3.78 | na |
| New Zealand | −4.0 Dec | +6.1 Q3 | −9.1‡ | 1.46 | 1.48 | 3.5 | 4.70 | 5.97 |
| Peru | +8.5 Nov | +1.8 Q3 | +0.7 | 3.19 | 3.28 | 0.1 | 4.39 | na |
| Philippines | −4.4 Nov | +4.4 Sep | +3.1 | 48.4 | 51.8 | −0.5 | 5.56 | na |
| Portugal | −23.1 Oct | −17.0 Nov | −7.9‡ | 0.77 | 0.84 | −3.7 | 3.78 | 4.16 |
| Slovakia | −3.5 Nov | −5.4 Oct | −6.2‡ | 26.5 | 31.5 | −3.0 | 4.19 | 4.33 |
| Slovenia | −2.0 Nov | −1.1 Nov | −1.6‡ | 0.77 | 0.84 | −1.2 | na | na |

*Merchandise trade only. †The Economist poll. ‡Economist Intelligence Unit forecast. §Dollar-denominated bonds.

**Sources:** National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

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# Markets

Feb 8th 2007
From The Economist print edition

## Markets

| | Index Feb 7th | % change on one week | % change on Dec 30th 2005 in local currency | % change on Dec 30th 2005 in $ terms |
|---|---|---|---|---|
| United States (DJIA) | 12,666.9 | +0.4 | +18.2 | +18.2 |
| United States (S&P 500) | 1,450.0 | +0.8 | +16.2 | +16.2 |
| United States (NAScomp) | 2,490.5 | +1.1 | +12.9 | +12.9 |
| Japan (Nikkei 225) | 17,292.3 | −0.5 | +7.3 | +5.0 |
| Japan (Topix) | 1,728.4 | +0.4 | +4.8 | +2.5 |
| China (SSEA) | 2,852.0 | −2.6 | +133.6 | +143.3 |
| China (SSEB, $ terms) | 172.6 | +7.4 | +167.2 | +178.3 |
| Britain (FTSE 100) | 6,369.5 | +2.7 | +13.4 | +30.1 |
| Canada (S&P TSX) | 13,142.3 | +0.8 | +16.6 | +14.9 |
| Euro area (FTSE Euro 100) | 1,324.2 | +1.6 | +21.6 | +34.2 |
| Euro area (DJ STOXX 50) | 4,251.1 | +1.7 | +18.8 | +31.1 |
| Austria (ATX) | 4,571.8 | +1.1 | +24.7 | +37.6 |
| Belgium (Bel 20) | 4,544.9 | +2.5 | +28.1 | +41.3 |
| France (CAC 40) | 5,703.0 | +1.7 | +20.9 | +33.5 |
| Germany (DAX)* | 6,915.6 | +1.9 | +27.9 | +41.1 |
| Greece (Athex Comp) | 4,729.9 | +0.4 | +29.1 | +42.5 |
| Italy (S&P/MIB) | 42,868.0 | +1.6 | +20.1 | +32.5 |
| Netherlands (AEX) | 509.1 | +1.9 | +16.6 | +28.6 |
| Spain (Madrid SE) | 1,651.0 | +2.4 | +42.8 | +57.6 |
| Czech Republic (PX) | 1,714.9 | +3.1 | +16.4 | +32.5 |
| Denmark (OMXCB) | 458.8 | +3.8 | +24.7 | +37.8 |
| Hungary (BUX) | 23,944.6 | −0.5 | +15.2 | +26.9 |
| Norway (OSEAX) | 530.0 | +1.3 | +40.7 | +53.0 |
| Poland (WIG) | 55,099.9 | +1.0 | +54.8 | +69.5 |
| Russia (RTS, $ terms) | 1,917.8 | +4.1 | +56.9 | +70.4 |
| Sweden (Aff.Gen) | 383.8 | +1.9 | +30.8 | +48.6 |
| Switzerland (SMI) | 9,288.2 | +1.7 | +22.5 | +30.2 |
| Turkey (ISE) | 42,099.0 | +2.2 | +5.8 | +1.9 |
| Australia (All Ord.) | 5,870.9 | +2.0 | +24.7 | +32.6 |
| Hong Kong (Hang Seng) | 20,679.7 | +2.9 | +39.0 | +38.0 |
| India (BSE) | 14,643.1 | +3.9 | +55.8 | +59.1 |
| Indonesia (JSX) | 1,764.9 | +0.4 | +51.8 | +65.3 |
| Malaysia (KLSE) | 1,243.6 | +4.6 | +38.2 | +49.5 |
| Pakistan (KSE) | 11,729.0 | +4.1 | +22.7 | +20.7 |
| Singapore (STI) | 3,236.6 | +3.6 | +37.9 | +49.6 |
| South Korea (KOSPI) | 1,426.3 | +4.9 | +3.4 | +12.0 |
| Taiwan (TWI) | 7,850.1 | +2.0 | +19.9 | +19.3 |
| Thailand (SET) | 675.3 | +3.3 | −5.4 | +12.8 |
| Argentina (MERV) | 2,100.1 | +1.4 | +36.1 | +32.8 |
| Brazil (BVSP) | 44,587.0 | −0.1 | +33.3 | +49.3 |
| Chile (IGPA) | 13,456.4 | +3.6 | +46.2 | +36.5 |
| Colombia (IGBC) | 10,911.4 | +1.1 | +14.7 | +17.3 |
| Mexico (IPC) | 28,123.8 | +2.0 | +58.0 | +53.7 |
| Venezuela (IBC) | 45,092.5 | +2.6 | +121.1 | +35.2 |
| Egypt (Hermes) | 60,711.7 | +4.3 | +9.7 | +10.4 |
| Israel (TA-100) | 982.8 | +2.6 | +18.7 | +28.8 |
| Saudi Arabia (Tadawul) | 7,328.1 | +4.1 | −56.2 | −56.2 |
| South Africa (JSE AS) | 25,915.9 | +1.8 | +43.2 | +26.5 |
| Europe (FTSEurofirst 300) | 1,547.0 | +2.1 | +21.3 | +33.8 |
| World, dev'd (MSCI) | 1,522.2 | +1.5 | +21.0 | +21.0 |
| Emerging markets (MSCI) | 928.6 | +3.0 | +31.4 | +31.4 |
| World, all (MSCI) | 377.1 | +1.6 | +21.8 | +21.8 |
| World bonds (Citigroup) | 652.1 | +0.4 | +5.1 | +5.1 |
| EMBI+ (JPMorgan) | 409.0 | +0.9 | +10.9 | +10.9 |
| Hedge funds (HFRX) | 1,305.0 | +0.8 | +11.8 | +11.8 |
| Volatility, US (VIX) | 10.3 | 10.4 | 12.1 | (levels) |
| CDSs, Eur (iTRAXX)† | 20.6 | −4.1 | −43.9 | −38.1 |
| CDSs, N Am (CDX)† | 26.4 | −5.4 | −42.8 | −42.8 |
| Carbon trading (EU ETS) € | 1.30 | −43.7 | −93.8 | −93.2 |

*Total return index. †Credit-default swap spreads, basis points.

**Sources:** National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac.

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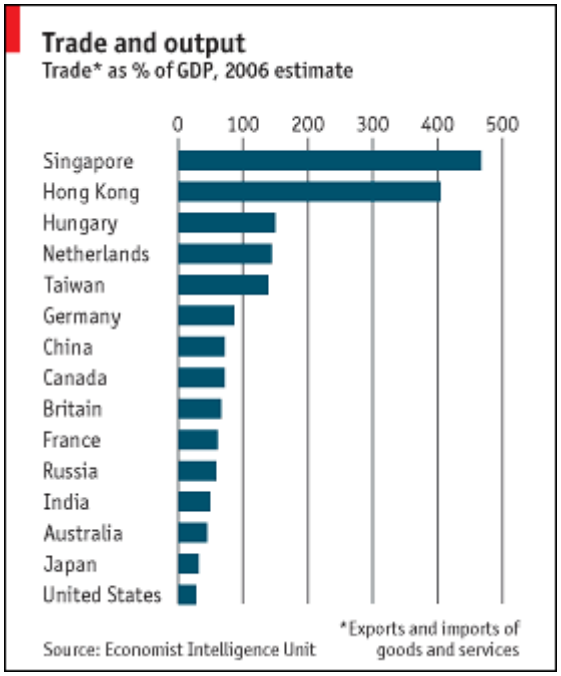
# Trade and output

Feb 8th 2007
From The Economist print edition




India's tariffs remain much higher than America's. The average duty it imposed on other members of the World Trade Organisation was over 18% in 2005, compared with the American average of less than 4%. But by another measure of global integration, India's economy is more open than America's. Its exports and imports amounted to almost 50% of GDP in 2006, according to estimates by the Economist Intelligence Unit, a sister company of *The Economist*. America's were only 28%. In stark contrast to these continental giants, Singapore and Hong Kong, two entrepôt economies, exist for trade. Their exports and imports amounted to over 400% of the size of their economies last year.

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